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INVESTMENT INCOME WITHHOLDING IN THE UNITED STATES AND GERMANY

by

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I. INTRODUCTION

In a reversal from its historical roots, the United States income tax system now taxes income from labor significantly more heavily than income from capital. It does so not only facially, through explicit preferences for income from capital, but also more subtly, through more hidden features of the tax system – specifically, enforcement strategies. This Article focuses on a prominent disparity in enforcement between the two forms of income: Wage income is subject to withholding while investment income is not. In its critical examination of this disparity, the Article first offers a brief history of withholding in the United States, in which withholding on wage income was eagerly embraced as a part of a patriotic war effort, while withholding on investment income was rejected again and again. The Article then contrasts the United States experience with that of Germany. Under Germany's remarkably robust constitutional principle of equality in taxation, the failure to withhold on interest income was held unconstitutional, and the German legislature was required to enact it. However, instead of leading to greater equality in tax enforcement, the new withholding law led to widespread evasion. The German experience is cited as a cautionary tale on the dangers of international tax competition. Yet, ultimately, it may prove to have been the tipping point for countries to engage in the cooperative behavior needed to overcome undesirable tax competition. The last Part of the Article draws upon lessons learned from past U.S. and German experiences to make the normative and practical case that now is the time to adopt investment income withholding in the United States.

II. THE TAXATION OF INCOME FROM LABOR AND INCOME FROM CAPITAL IN THE UNITED STATES

The United States tax system has almost always differentiated between income from capital, on the one hand, and income from labor, on the other. When originally adopted in 1913, the income tax was targeted to wealthy taxpayers' income from capital, which, until then, had largely escaped taxation under the scheme of consumption taxes that funded the federal government.[1] Lawmakers intended the upper classes to pay the lion's share of the income tax, in part to balance out the regressive effects of consumption taxes,[2] while lower income wage earners paid little or no income tax.[3] Not until World War II did the income tax begin to have a significant impact on wage earners, shifting from "class tax to mass tax," as Professor Carolyn Jones so aptly phrases it.[4]

Philosophically, income from labor was thought to be morally superior to income from capital. According to Professor Marjorie Kornhauser, the heightened moral status of income from labor is grounded in two important value systems – the Protestant equation of work with godliness and the republican conception of equality:

> Only by earning money can one do God's work and thus display signs of grace. Unearned income does not display the same grace. Moreover, since work is a calling through which one enhances the public good, one is only a trustee or steward of the wealth one has.... [T]he heir has no moral right to the wealth primarily because he did not earn it....
>
> Republican equality also affects attitudes about the source of wealth: it is acceptable to receive money as a result of one's own talent and industry because that is what America is about – equal opportunity for achievement based on merit. It is quite another thing to acquire money through inheritance, because that practice continues the influence of heredity, the "dead hand" of property.[5]

Considerations of fairness and distributive justice also favored taxing income from labor more lightly than income from capital. John Stuart Mill

1. See John Witte, The Politics and Development of the Federal Income Tax 77 (1985).

2. See generally Erik M. Jensen, The Taxing Power, the 16th Amendment, and the Meaning of "Incomes," 33 Ariz. St. L.J. 1057 (2001) (detailing lawmakers' concern, in adopting the income tax, that the tax burden be distributed appropriately across all classes, including the wealthy).

3. Fewer than 2% of workers filed income tax returns between 1913 and 1915. See Witte, supra note 1, at 78.

4. Carolyn C. Jones, Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II, 37 Buff. L. Rev. 685 (1989). As compellingly documented by Professor Jones, the transformation of the income tax took place quickly and completely. In 1942, 42 million taxpayers paid income taxes in 1945, compared to 7 million in 1940. Id. at 686. By 1943, 68.9% of Americans were subject to the income tax, compared to just 2.6% in 1933. Id. at 695.

5. Marjorie E. Kornhauser, The Morality Of Money: American Attitudes Toward Wealth and the Income Tax, 70 Ind. L.J. 119, 128-29 (1994).

argued that those who work for a living have less ability to pay taxes than those who live off accumulated capital because they have only a finite period of time in which they can work and must save for retirement and illness.[6] A related argument is that those who earn income from labor must sacrifice leisure, and therefore are less well off than those whose income is derived from capital.[7]

In a remarkable reversal from its historic and philosophical roots, today's tax system strongly prefers income from capital over income from labor. This is most prominently evidenced by the differing rates of tax imposed on the two categories of income – a maximum effective rate of 35% on earned income and generally 15% on long term capital gains and dividends.[8] The recent controversy surrounding huge payouts to private equity and hedge fund managers illustrates the stakes. In 2006, the top 25 hedge fund managers were reportedly paid an average of $570 million, with the high payout at $1.7 billion. If characterized as compensation from labor, the payouts would be subject to tax at 35%; if, on the other hand, treated as investment returns, they would be taxed at a mere 15%.[9]

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6. 2 John Stuart Mill, Principles of Political Economy 315 (The Colonial Press 1899) (Bk. V, Ch II). Mill ideally would have exempted all savings from tax, but short of that, supported a lighter tax on income from labor than income from capital. See Marjorie E. Kornhauser, Equality, Liberty, and a Fair Income Tax, 23 Fordham Urb. L.J. 607, 658-59 (1996); Edward J. McCaffery, A New Understanding of Tax, 103 Mich. L. Rev. 807, 809-12 (2005).

7. This argument is advanced by the British Mead Committee in its report recommending the adoption of a gratuitous wealth transfer tax. See J. E. Meade, Institute for Fiscal Studies, The Structure and Reform of Direct Taxation 350 (1978) [hereinafter Meade Report]. Though describing the Meade Report as "distinguished," Professor Eric Rakowski dismisses this argument as "not worth lingering over." Eric Rakowski, Can Wealth Taxes Be Justified, 53 Tax L. Rev. 263, 334, 358 (2000).

8. IRC § 1. Some forms of income from capital, such as interest, rents and royalties, are taxed at the same rates as earned income. In addition, the 15% tax rate on dividends is scheduled to expire on Dec. 31, 2010. Economic Growth and Tax Relieve Reconciliation Act of 2001, P.L. 107-16, § 901(a)-(b), 115 Stat. 38 (2002).

9. See Lee A. Sheppard, Blackstone Proves Carried Interests Can Be Valued, 115 Tax Notes 1236 (June 25, 2007). Ms. Sheppard reports that the top 25 hedge fund managers were paid an average of $570 million in 2006, with the high payout at $1.7 billion, and argues that the payouts ought to be taxed at ordinary income rates as compensation, rather than at capital gains rates as a "carried interest" (a speculative profits interest in a partnership). She notes that former Treasury Secretary Robert Rubin, and even the "notoriously antitax" Economist magazine, endorse this view. See Victor Fleischer, Two and Twenty: Taxing Partnership Profits in Private Equity Funds, 83 N.Y.U. L. Rev. 1 (2008) (arguing against capital gain treatment of carried interests); David A. Weisbach, Professor Says Carried Interest

The other most prominent difference in the treatment of income from capital and income from labor is that the latter is subject to additional taxes under the Federal Insurance Contribution Act.[10] These payroll taxes, intended to fund Social Security and Medicare, have been called the "neglected stepchild of policy analysis," often ignored because academics and policymakers find them conceptually uninteresting or dislikeably regressive.[11] However, it is becoming increasingly hard to ignore their impact. In 2008, payroll taxes accounted for 36% of total federal receipts,[12] and, as of 1999, almost two-thirds of families paid more in payroll taxes than in income taxes.[13] Payroll taxes contribute significantly to the heavy tax burden on income from labor.

Income from capital is treated favorably in a variety of other ways.[14] For example, the tax on capital gains is deferred until the occurrence of a realization event, further lowering the effective rate of tax. If an appreciated asset is held until death, the tax is entirely eliminated.[15] Gains realized on

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Legislation Is Misguided, 116 Tax Notes 505 (Aug. 6, 2007) (arguing for capital gain treatment of carried interests).

10. Federal Insurance Contributions Act, IRC §§ 3101-3128 [hereinafter, FICA]. FICA imposes a tax of 6.2% on wages up to $102,000 (in 2008) and an additional 1.45% with no cap. IRC §§3101, 3111. See generally, Deborah A. Geier, Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income, 22 Va. Tax Rev. 1 (2002).

11. Patricia E. Dilley, Breaking the Glass Slipper – Reflections on the Self-Employment Tax, 54 Tax Law. 65, 65 (2000).

12. Congressional Budget Office, Budget and Economic Outlook: Fiscal Years 2009 to 2019, at 16, Table 5 (2009).

13. Andrew Mitrusi & James Poterba, The Changing Importance of Income and Payroll Taxes on U.S. Families, 15 Tax Pol'y & Econ. 95, 101 (2001).

14. See generally William J. Turnier, Theory Meets Reality: The Case of the Double Tax on Material Capital, 27 Va. Tax Rev. 83 (2007) (detailing comprehensively ways in which income from capital and income from labor are treated differently). Professor Turnier begins with proposition that a pure income tax actually taxes income from capital more heavily than income from labor. Id. at 89-93. However, once he examines specifics of our actual system, he states that, particularly in light of payroll taxes, "most reasonable observers [would] conclude that, under the Code, human capital bears at least, and likely more than, its fair share of the tax burden." Id. at 125.

15. In general, gains of property held at death are free from income tax because the transferee of the property takes a basis equal to the property's fair market value on the date of the decedent's death. IRC §1014. Of course, the transferred property may be subject to the estate tax, if the decedent's taxable estate is large enough and if the decedent neglects to engage in the wealth of planning opportunities that allow him to minimize the estate tax. Professor McCaffery has formulated a memorable summary of all a taxpayer needs to do to avoid income and estate tax on financial capital: "Buy, Borrow, Die." McCaffery, supra note 6, at 890.

"like-kind exchanges" are deferred,[16] and gains realized on the sale of a principal residence are exempt.[17]

To be sure, income from capital is not always treated more favorably than income from labor. It is easy to come up with examples to the contrary. Thus, for example, dividend income is nominally taxed twice under our classical system of corporate taxation, first at the corporate level when earned, and then at the shareholder level when distributed.[18] And while income from labor is taxed at more than double the rate of capital gains and dividends (at the maximum rates), and is subject to additional, significant payroll taxes, it receives favorable treatment in other respects. For example, imputed income from services performed for oneself or one's family is untaxed.[19] At low income levels, the earned income tax credit arguably produces a negative tax rate.[20]

Nonetheless, it is clear that the balance has shifted in favor of income from capital over income from labor.[21] The next Part examines the more hidden ways in which income from capital is preferred – in particular, through enforcement strategies.

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16. IRC § 1031.

17. IRC § 121.

18. See generally Jennifer Arlen & Deborah M. Weiss, A Political Theory of Corporate Taxation, 105 Yale L.J. 325 (1995); Terrence R. Chorvat, Apologia for the Double Taxation of Corporate Income, 38 Wake Forest L. Rev. 239 (2008).

19. See generally Nancy C. Staudt, Taxing Housework, 84 Geo. L.J. 1571 (1996).

20. I say "arguably" because when viewed in conjunction with payroll taxes, the earned income credit does not result in a negative tax rate. See generally Anne L. Alstott, The Earned Income Tax Credit and the Oversimplified Case for Tax-Based Welfare Reform, 108 Harv. L. Rev. 533 (1995).

21. See John Buckley, Tax Changes Since Woodworth's Time: Implications for Future Tax Reform, 34 Ohio N.U. L. Rev. 1, 7-8 (2008); Turnier, supra note 14, at 125; Stewart Karlinsky & Hughlene Burton, America's Inexorable Move to a Consumption-Based Tax System, or, Why Warren Buffett is Winning the Class Tax War, 105 Tax Notes 699, 699-700 (Nov. 1, 2004).

As Professor Kornhauser observes, the shift has not been linear. Tax law changes have sometimes favored income from labor and sometimes favored income from capital, reflecting Americans' ambivalent attitudes about wealth. Kornhauser, supra note 5, at 168-70. See also, Dennis J. Ventry Jr., Equity versus Efficiency and the U.S. Tax System in Historical Perspective, in Tax Justice (eds. Joseph J. Thorndike & Dennis J. Ventry Jr. 2002) at 25-70. Though Professor Kornhauser believes that the current system is a sincere reflection of our conflicting attitudes about wealth, I am more cynical than she, and believe it increasingly promotes the interests of the powerful and wealthy.

III. DISPARATE TAX ENFORCEMENT IN THE UNITED STATES

A. In General

The preceding Part describes explicit aspects of the preferential tax treatment of income from capital. This preference for income from capital is also discernible in more subtle ways. In particular, enforcement strategies with respect to income from capital and income from labor diverge quite dramatically. The recently enacted "tax holiday" of section 965 as a response to the "deferral problem"[22] exemplifies the ineffectual enforcement effort often undertaken with respect to income from capital. In 1998, the Treasury Department and Internal Revenue Service sought, through regulatory action, to limit a major cause of the deferral problem.[23] Faced with a firestorm of objections by corporate taxpayers and their lobbyists,[24] and under pressure from Congress, the IRS retreated. Untaxed profits continued to accumulate offshore. Then, in 2004, Congress enacted section 965, under which the multinationals were able to repatriate earnings at a tax cost hundreds of billions of dollars less than they would ordinarily have incurred.[25] The tax holiday was purportedly a *quid pro quo*, under which, in exchange for the low rate of tax on repatriated earnings, the multinationals were supposed to invest the earnings domestically. However, critics of the holiday characterize it as a pure windfall to the multinationals.[26]

The proliferation of tax shelters in the last decade provides another example of the ineffectual enforcement efforts on income from capital. This recent generation of shelters was largely designed to reduce corporate tax liabilities, ultimately benefiting the return on corporate investment.[27] Another

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22. "Deferral problem" refers to the ability of multinational corporations to defer offshore profits that probably ought to have been taxed currently under Subpart F principles. See generally Keith Engel, Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle With Subpart F, 79 Tex. L. Rev. 1525 (2001); Lawrence Lokken, Whatever Happened To Subpart F? U.S. CFC Legislation after the Check-the-Box Regulations, 7 Fla. Tax Rev. 185 (2005).

23. See Notice 98-11, 1998-1 C.B. 433.

24. See Engel, supra note 22, at 1552-57.

25. See Martin A Sullivan & Lee A. Sheppard, Multinationals Accumulate to Repatriate, 122 Tax Notes 295 (Jan. 19, 2009); Robert Goulder, If in Doubt, Blame Check the Box, 119 Tax Notes 1061 (June 9, 2008).

26. See Lynnley Browning, A One-Time Tax Break Saved 843 Corporations $265 Billion, N. Y. Times, June 24, 2008 ("It basically worked out to be one big giveaway," quoting Robert Willens, a tax and accounting authority in New York); see also, Lisa M. Nadal, Repatriation Gluttony – Was It Worth It? 119 Tax Notes 1228 (June 23, 2008).

27. See generally Joseph Bankman, The New Market in Corporate Tax Shelters, 83 Tax Notes 1775 (June 21, 1999).

major area of enforcement failure is in the collection of taxes on capital gains, where no meaningful efforts are made to prevent taxpayers from overstating basis.[28]

This is not to say that enforcement efforts do not also fall short in collecting tax on income from labor. Notably, sole proprietors of unincorporated businesses, who presumably derive a significant proportion of their income from their labor, are among the least compliant taxpayers, and, in 2001, accounted for an estimated $68 billion of the $345 billion tax gap.[29] But when it comes to collecting tax on wages paid to employees, one enforcement mechanism has been devastatingly effective: wage withholding.[30]

B. Withholding

Withholding is a simple concept. The payor holds back a portion of a payment and remits it to the tax authorities, to be applied against the payee's tax liability. Modern wage withholding came in during the World War II, and the tax system has never looked back.[31] Withholding was particularly useful during wartime, when revenue needs were high, immediate, and volatile.[32] In addition, it was an attractive way to ensure collection from the expanded rolls of new taxpayers, who had no experience filing a tax return or putting funds aside for the payment of taxes.[33] Withholding first gained a toehold in 1942, as the means for collecting the "Victory Tax," a special 5%

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28. See Joseph M. Dodge & Jay A. Soled, Inflated Tax Basis and the Quarter-Trillion-Dollar Revenue Question, 106 Tax Notes 453, 454-61 (Jan. 24, 2005) (taxpayers overstate tax basis with impunity because there are no serious deterrents from doing so, underpaying taxes by an estimated $250 billion over 10 years).

29. See IRS Tax Gap Facts and Figures, 11 available at http://www.irs.gov/pub/irs-utl/tax_gap_facts-figures.pdf; U.S. Gov't Accountability Office Report to the Committee on Finance, U.S. Senate, Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance (July 2007), available at http://www.gao.gov/new.items/d071014.pdf.

30. IRC § 3402.

31. For a history of withholding, see generally, Richard L. Doernberg, The Case Against Withholding, 61 Tex. L. Rev. 595, 599-603 (1982); Jones, supra note 4, at 695-99; Charlotte Twight, Evolution of Federal Income Tax Withholding: The Machinery of Institutional Change, 14 Cato J. 359, 367-90 (1995).

The United States' first experience with income tax withholding – on wages and interest – actually occurred from 1913 to 1917. It was extremely unpopular, and it was replaced in 1917 by an information reporting system. See Doernberg at 600.

32. See Doernberg, supra note 31, at 601; Jones, supra note 4, at 697.

33. See Doernberg, supra note 31, at 601-02; Jones, supra note 4, at 695-96.

gross income tax on wages and salaries.[34] Just one year later in 1943, extolling taxpayer convenience and patriotic sacrifice, Congress enacted comprehensive wage withholding.[35]

Withholding has proven to be *the* single most effective enforcement mechanism for collecting taxes on income from labor.[36] The "tax gap" for wage income – the amount by which taxpayers fail to file their returns and pay the tax due on time – has consistently been measured at less than 1%.[37] (By way of comparison, the overall tax gap is estimated to be 15% - 16%.)[38] Withholding could easily be adopted for dividends, interest and other investment income, which are currently subject to information reporting.[39]

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34. See Doernberg, supra note 31, at 601; Jones, supra note 4, at 695.

35. See Doernberg, supra note 31, at 602-03; Twight, supra note 31, at 382-85.

36. See generally, Leandra Lederman, Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance, 60 Stan. L. Rev. 695, 698, 731-33 (2007) (withholding uses both employee and employer as third party enforcer of their respective obligations); Edward K. Cheng, Structural Laws and the Puzzle of Regulating Behavior, 100 Nw. U. L. Rev. 655, 675-81 (citing withholding as an example of effective "structural" enforcement mechanism); Piroska Soos, Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues, 24 U.C. Davis L. Rev. 107, 126-130 (1990) (withholding is an efficient, reliable way to collect tax; it improves compliance in payment and reporting); but see Doernberg, supra note 31, at 603-31 (analyzing the shortcoming of withholding as an enforcement mechanism).

37. IRS, U.S. Dep't of the Treasury, Federal Tax Compliance Research: Individual Income Tax Gap Estimates for 1985, 1988, and 1992 [hereinafter Tax Gap Estimates], at 8 tbl. 3, 15 tbl. 7 (rev. ed. 1996) (tax gap information for 1992, 1988, and 1985). This data was collected by the IRS under its Taxpayer Compliance Management Program (TCMP). The TCMP was discontinued in 1994, so comparable data from more recent years is not available. The program was revived by former IRS Commissioner Charles Rossotti in 2002, and renamed the National Research Program (NRP). See IRS New Release, IRS Moves to Ensure Fairness of Tax System; Research Program Works to Increase Compliance Program Effectiveness, Reduce Burdens on Taxpayers, Rel. No. IR-2002-05 (Jan. 16, 2002). The NRP has compiled and published tax gap data for 2001, and the tax gap for income subject to withholding appears to be in a similar range. IRS Tax Gap Facts and Figures, at 11 (reporting a tax gap of 1.2% – 1.4% for wages, salaries, tips, etc.). See Eric Toder, What is the Tax Gap?, 117 Tax Notes 367 (Oct. 22, 2007) (describing the preliminary findings of the NRP and ways in which its methodology differs from the TCMP).

38. See Tax Gap Estimates, at 8 tbl.3, 15 tbl. 7.

39. Compliance rates for income subject to information reporting are better than for all sorts of income, but not as high as for income subject to withholding. See Michael Brostek, TAX GAP: Multiple Strategies, Better Compliance Data, and Long-Term Goals are Needed to Improve Taxpayer Compliance, GAO, Oct. 25, 2005, available at http://www.gao.gov/new.items/d06208t.pdf (putting the rate of

Indeed, many other industrialized countries do impose withholding on investment income.[40] It is therefore mystifying that the United States has not availed itself of this powerful enforcement tool to collect taxes on investment income.

Perhaps our reluctance is not mystifying, but rather, all too predictable, in light of the interests opposed to investment income withholding. In 1942 and 1943, wage withholding was embraced in the throes of a patriotic fever that inspired such slogans as "Taxes to Beat the Axis."[41] Withholding on dividends and interest, on the other hand, was proposed, but withdrawn in the face of objections by banks and corporate interests.[42]

In the years that followed, many legislators and policymakers continued to be intrigued by the idea of deploying the powerful enforcement mechanism of withholding to collect taxes on investment income as well as wages. Just as clearly, banks continued to resist the idea. In 1950, the House

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noncompliance for income subject to some information reporting at 7.1% and for income subject to substantial information reporting at 4.2%). See also, James B. Mackey, Narrowing the Tax Gap, at slide 7, available at http://www.irs.gov/pub/irs-soi/07researchtaxgapmackie.ppt (putting the tax gap for information reporting at 4.5%). However, the compliance rates for all investment income – including unreported income from hidden offshore accounts – is likely dramatically lower than this. See Joseph Guttentag & Reuven Avi-Yonah, Closing the International Tax Gap, in Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration (Max B. Sawicky, ed., 2006) (estimating offshore tax evasion by individuals at $40-$70 billion annually in lost U.S. tax revenues).

40. For withholding in Australia, see, 951-3rd Foreign Income Portfolios (BNA) at XII-A (withholding on interest); for withholding in Germany, see, Jorg-Dietrich Kramer, Germany, 3 Tax Notes Int'l 853, 854-855 (Aug. 1991) (interest withholding); for withholding in Israel, see, 967-4th Foreign Income Portfolios (BNA) at XI-E (interest, dividend, and miscellaneous other withholding provisions); for withholding in Italy, see, 968-3rd Foreign Income Portfolios (BNA) at X-H(1) (withholding on select dividend and interest income); for withholding in New Zealand, see, 975-2nd Foreign Income Portfolios (BNA) at XI-D (withholding on most dividends); for withholding in the Netherlands, see, 973-2nd Foreign Income Portfolios (BNA) at IX-A and VII-B(2) (withholding on dividends); for withholding in Puerto Rico, see, 980-1st Foreign Income Portfolios (BNA) at X-E (withholding on dividends from certain, mostly resident corporations); for withholding in Switzerland, see, 986-3rd Foreign Income Portfolios (BNA) at XII-E (withholding on most interest, dividends, and investment income); for withholding in the UK, see, HMRC, Revenue and Customs Brief 47/08, available at http://www.hmrc.gov.uk/briefs/company-tax/brief4708.htm (withholding on interest).

41. Jones, supra note 4, at 723 (describing a Treasury commissioned pro-tax film starring Donald Duck, filling out a tax return).

42. See Doernberg, supra note 31, at 600-01.

of Representatives passed legislation imposing withholding on dividends, interest, and royalties.[43] The Senate rejected the provision in the final bill.[44] In 1951, the House tried again;[45] again, the Senate refused.[46]

The Kennedy administration put forth a dividend and interest withholding proposal again, in 1962. The House approved a bill providing for withholding at a rate of 20% on interest and dividends,[47] and again, the financial services industry managed to beat it back.[48] Congress instead expanded and strengthened the information reporting scheme for interest and dividends, persuaded by the banks that this would work equally well in improving compliance.[49] This has not proven to be the case.[50]

In 1980, the Carter administration proposed a 15% withholding tax on interest and dividend payments[51] as part of a package of anti-inflationary measures.[52] The proposal of the unpopular president was given a chilly reception by the House. Only one Congressman expressed support for the new tax, and the proposal died quickly and quietly.[53]

Finally, *mirabile dictu*, Congress succeeded in enacting dividend and interest withholding, as part of the Tax Equity and Fiscal Responsibility Act of 1982.[54] The law was enacted over the objections of the financial services industry (and many lawmakers) as a result of "astute parliamentary leadership"[55] and strong support from the charismatic and popular President Reagan.[56] The financial services industry protested that withholding would

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43. H.R. 8920, 81st Cong. (1950).

44. Revenue Act of 1950, S. Rep. No. 2375, 81st Cong., 2d Sess. (1950).

45. H.R. Rep. No. 586, 82nd Cong., (1951).

46. Revenue Act of 1951, S. Rep. No. 781, 82nd Cong., (1951).

47. H.R. Rep. No. 1447, 87th Cong., 2d Sess. (1962).

48. See John T. Scholz, Compliance Research and the Political Context of Tax Administration, in 2 Taxpayer Compliance: Social Science Perspectives (Jeffrey A. Roth & John T. Scholz eds., 1989) at 22).

49. See Doernberg, supra note 31, at 632-41 (setting forth history of information reporting and its inadequacies compared to withholding).

50. See Doernberg, supra note 31, at 632-41 (setting forth history of information reporting and its inadequacies compared to withholding).

51. See Judith Miller, Withholding on Interest, Dividends to be Asked, N.Y. Times, Mar. 14, 1980.

52. See Edward Cowan, Taxes Withholding Plan on Interest, N.Y. Times, Apr. 28, 1980.

53. President's Proposal for Withholding on Interest and Dividends: Hearing Before the House Comm. on Ways and Means, 96th Cong., 96-92 (1980); see also Edward Cowan, Committee Is Cool to Dividend Withholding Tax, N.Y. Times, Apr. 30, 1980.

54. The Tax Equity and Fiscal Responsibility Act of 1982 [hereinafter TEFRA] § 301, Pub. L. No. 97-248, 96 Stat. 324.

55. See Scholz, supra note 48, at 22.

56. See Twight, supra note 31, at 389.

impose undue hardship on elderly or low income individuals, and small savers; Congress responded by exempting these payments from the new law.[57] Banks and corporations also complained that withholding would unfairly shift the cost of collecting the tax from the government to them; again, Congress accommodated them by allowing them to invest the withheld amounts for 30 days before remittance to the government.[58]

Finally, in desperation, the financial services industry managed to procure a six month delay in the start of the new law, until July 1, 1983, pleading that they needed more time to implement withholding. Instead, they used the extra time to launch a national campaign for the repeal of the law. According to a report prepared by the U.S. House of Representatives Democratic Study Group, banks included inserts in the year-end statements mailed to millions of depositors, telling them that "10% of your savings is going to disappear" because of the withholding law, and that "the government is going to loot your savings." Bank statements also included form letters and postcards for customers to mail to members of Congress urging repeal of the law. Measured by the amount of "protest mail" Congress received, interest and dividend withholding was more unpopular than the Vietnam War.[59]

The financial services industry prevailed, and in 1983, dividend and interest withholding was repealed retroactively without ever having taken effect.[60] The industry's victory was decried by Treasury officials, members of the tax bar, and commentators as a historic low point in the precedence of special interests over the common good.[61] Withholding, used continuously and highly successfully to collect taxes on income from labor since 1942, has never been used to collect taxes on income from capital.[62]

57. TEFRA § 301. See Michael H. Hoeflich, Withholding at Source on Non-Wage Income: A Brief Historical Excursus, 19 Tax Notes 678, 679 (May 23, 1982).

58. Id.

59. See H.R. Rep. No. 98-7, Special Report, U.S. House of Representatives Democratic Study Group (1983).

60. Interest and Dividend Tax Compliance Act of 1983 § 102(a), Pub. L. No. 98-67, 97 Stat. 369. See generally Hoeflich, supra note 57 (noting the parallels between the TEFRA and the 1917 repeal of withholding).

61. See Federal Bar Association's Section of Taxation, The Condition of the Tax Legislative Process, 39 Tax Notes 1581, 1590 (June 27, 1988) ('grassroots' lobbying regarding TEFRA interest and dividend withholding provision was inappropriate).

62. Dividends and interest and security sale proceeds are subject to backup withholding in cases where taxpayers fail to provide taxpayer identification information. IRC § 3406. However, unlike wage withholding, backup withholding can be avoided by providing the required information.

IV. GERMANY'S WITHHOLDING EXPERIENCE

A. *Constitutional Limits on Tax Legislation: Background*

Germany's experience with disparate enforcement of its tax laws presents a vivid contrast to that of the United States, most importantly because of the German Federal Constitutional Court's interpretation of Germany's Basic Law. As Professor Ordower demonstrates in his authoritative article, the Constitutional Court is much more inclined than the U.S. Supreme Court to invoke constitutional equality principles to limit and shape tax laws.[63] Thus, for example, the Constitutional Court has interpreted the general equality clause of the Basic Law,[64] in conjunction with the constitutional protection of the family,[65] to require that a subsistence

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63. See Henry Ordower, Horizontal and Vertical Equity in Taxation as Constitutional Principles: Germany and the United States Contrasted, 7 Fla. Tax Rev. 259, 259-335 (2006); see also Hugh J. Ault & Brian J. Arnold, Comparative Income Taxation: A Structural Analysis 54 (2d ed. 2004); David P. Currie, The Constitution of the Federal Republic of Germany 52-60 (1994); Gerald L. Neuman, Constitutional Equality: Equal Protection, "General Equality" and Economic Discrimination from a U.S. Perspective, 5 Colum. J. Eur. L. 281, 308-09 (1999) (noting that the Constitutional Court has applied equality principles particularly vigorously in the context of tax laws).

Cf. Stephen W. Mazza & Tracy A. Kaye, Restricting the Legislative Power to Tax in the United States, 54 Am. J. Comp. L. 641, 641-670 (2006) (describing potential constitutional challenges on the legislative power to tax, but concluding that most challenges fail due to courts' extreme deference to the legislature on tax matters).

64. Article 3 (Equality before the law)

(1) All persons shall be equal before the law.

(2) Men and women shall have equal rights. The state shall promote the actual implementation of equal rights for women and men and take steps to eliminate disadvantages that now exist.

(3) No person shall be favored or disfavored because of sex, parentage, race, language, homeland and origin, faith, or religious or political opinions. No person shall be disfavored because of disability.

65. Id. at Art. 6 (Marriage and the family; children born outside of marriage)

(1) Marriage and the family shall enjoy the special protection of the state.

(2) The care and upbringing of children is the natural right of parents and a duty primarily incumbent upon them. The state shall watch over them in the performance of this duty.

(3) Children may be separated from their families against the will of their parents or guardians only pursuant to a law, and only if the parents or guardians fail in their duties or the children are otherwise in danger of serious neglect.

minimum be exempt from tax, and further, that the exempt amount be adjusted to take into account dependent children.[66] Similarly, the Court has held that mandatory joint filing by married couples is constitutionally prohibited where it would result in a marriage penalty (that is, a greater tax liability for the married couple than for two unmarried individuals with comparable income).[67]

The Court has also flexed its constitutional muscle in tax areas outside of family and personal expenses. It invalidated the inheritance tax and the wealth tax because their valuation methods undervalued real property, which resulted in a disproportionately low tax burden on taxpayers owning real property relative to taxpayers owning other sorts of property.[68]

> (4) Every mother shall be entitled to the protection and care of the community.
>
> (5) Children born outside of marriage shall be provided by legislation with the same opportunities for physical and mental development and for their position in society as are enjoyed by those born within marriage.

66. See Ordower, supra note 63, at 308-16; Neuman, supra note 63, at 309; Rainer Prokisch & Michael Rodi, German Constitutional Court Rules Amount of Basic Allowance for Income Tax Purposes is Unconstitutional, 6 Tax Notes Int'l 137 (Jan. 18, 1993); Willi Leibfritz, Wolfgang Buttner & Ulrich van Essen, The Tax System of Germany, 10 Tax Notes Int'l 465, 481-82 (Feb. 6, 1995). See also Johannes Frey & Axel Mielke, German Courts Issue Landmark Decision on Family Tax Benefits, 18 Tax Notes Int'l 839 (Mar. 1, 1999); Ralph Atkins, German Court Says Tax Breaks Must Extend to Married Couples, 18 Tax Notes Int'l 453 (Feb. 1, 1999) (tax allowances for single parents constitutionally required for married couples with children).

As Professor Ordower points out, the notion that deductions for basic living expenses are constitutionally mandated would be considered outlandish under United States law, where such deductions are allowed only as a matter of legislative grace. See Ordower, supra note 63, at 308. As a policy matter, though, the idea of exempting subsistence amounts is an appealing one. See Deborah A. Geier, The Taxation of Income Available for Discretionary Use, 25 Va. Tax Rev. 765 (2006).

67. See Ordower, supra note 63, at 318-23. As a result of the Court's decision, the legislature adopted an elective joint filing system for married couples. Id.

68. See Ordower, supra note 63, at 327-28; Jens Blumenberg, German Taxation of Real Estate Based on Assesses Unit Values Held Unconstitutional, 11 Tax Notes Int'l 703 (Sept. 11, 1995). The wealth tax has not been in effect since 1997. The valuation rules for the inheritance tax were amended to cure the constitutional deficiencies and allow the inheritance tax to continue. However, in 2007, the Court found other valuation rules under the inheritance tax to be unconstitutional. See Darryl Tait, Court Declare Inheritance Tax Unconstitutional, 45 Tax Notes Int'l 552 (Feb. 12, 2007); Clemens Phillip Schindler & Sima Maria Qamar, Inheritance Taxes in Austria and Germany, 46 Tax Notes Int'l 1221 (June 18, 2007). The Court required the tax to be amended by Dec. 31, 2008, which the

In the area of business taxes, the Court struck down a turnover tax exemption for laboratory medical services because it was available only to unionized labs, thereby discriminating against independent labs.[69]

The Court has not shied away from scrutinizing the finer details of the tax law. For example, the Court invalidated – on the grounds that it violated the constitutional equality principle and the family protection principle – a two-year limit on the deductibility of duplicate household expenses.[70] The Court also recently struck down a provision eliminating a commuting tax allowance for commutes of 20 kilometers or less.[71]

In view of the Court's assertive approach with respect to tax matters, it is perhaps not surprising that tax enforcement measures would also be tested under the constitutional equality principle. Specifically, with respect to taxes imposed on investment income, the Court has on two occasions found that inadequate enforcement in the collection of the taxes violated the equality principle. The following section describes the German experience with withholding on investment income.

B. Constitutional Mandate for Withholding on Interest Income

Under German law, interest and dividends are included in the income, but collection efforts have historically been minimal, particularly with respect to interest.[72] Prior to 1988, banks and other interest payors were not required to withhold or make information reports with respect to interest payments. Moreover, bank secrecy laws prohibited tax auditors of banks

German legislature managed to do by the skin of its teeth. See Wolfgang Kessler & Rolf Eicke, The New German Inheritance and Gift Tax Act, 53 Tax Notes Int'l 233 (Jan. 19, 2009).

69. See Ordower, supra note 63, at 328; Neuman, supra note 63, at 309. In several other cases challenging turnover tax provisions, however, the Court has declined to act. See Ordower, supra note 63, at 328-29.

70. See Ordower, supra note 63, at 303-308. The Court considered the situation of a worker in a single location, away from home – who ended up being employed there for more than two years through the repeated extension of a short-term assignment – to that of a worker who is away from home for more than two years as a result of short-term assignments to multiple locations. Comparing the two, the Court found that the two-year rule unfairly limited the ability of the single-location worker to deduct duplicate living expenses. The Court also found the two-year rule to be invalid as it applied to two-earner married couples, because it could result in a heavier tax burden on such couples as compared to single-earner couples, who could more easily relocate to eliminate duplicate living expenses. Id.

71. See Niko Harig, Commuter Tax Allowance Cutback Unconstitutional, Court Says, 52 Tax Notes Int'l 853 (Dec. 15, 2008); Niko Harig, Germany's Constitutional Court to Rule on Cutback of Commuter Tax Allowance, 51 Tax Notes Int'l 978 (Sept. 22, 2008).

72. See Ault & Arnold, supra note 63, at 67.

from gaining access to account holder information to ensure that the account holders were reporting the interest income.[73] The compliance rate was very low.[74]

In 1989, a new withholding tax was put into place, at the relatively modest rate of 10%, with respect to interest paid by banks.[75] It caused a massive capital flight as depositors moved their funds from German banks to the Luxembourg banks' subsidiaries,[76] and six months later, the tax was repealed.[77] Predictably, the low compliance rate with respect to interest income returned.[78]

In 1991, the Constitutional Court found that the tax on interest income violated the constitutional equality principle. The case was brought by a taxpayer who had reported his interest income and then challenged the legality of the tax on the grounds that it unfairly burdened voluntarily compliant taxpayers.[79] The Court interpreted the equality principle to require the tax burden to fall equally on all taxpayers both as a legal and a factual matter.[80] Because the tax on interest was not enforced, and had high levels of noncompliance, it disproportionately burdened taxpayers who voluntarily reported and paid taxes on their interest income.[81] The Court did not

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73. See id. Jorg-Dietrich Kramer, Germany, 3 Tax Notes Int'l 853, 855 (Aug. 1991). Richard Minor, German Parliament Committee Compromises on New Interest Withholding Tax Bill, 5 Tax Notes Int'l 63, 63 (July 13, 1992).

74. See Ault & Arnold, supra note 63, at 67.

75. See Leif Muten, International Experience of How Taxes Influence the Movement of Private Capital, 8 Tax Notes Int'l 743, 746 (Mar. 14, 1994). At the same time, it appears that bank secrecy laws were strengthened. See Kramer, supra note 73, at 855.

76. An estimated 120 billion marks flowed out of West Germany in 1988, in part out of concern about the imposition of withholding taxes. See Ferdinand Protzman, 10% Withholding Tax Abolished in Germany, N.Y. Times, Apr. 28, 1989. See also H. Schlesinger, Capital Outflow and Taxation – the Case of the Federal Republic of Germany, in Reforming Capital Income Taxation (H. Siebert ed., 1990) 101-09.

77. See Muten, supra note 75, at 746. The heightened secrecy laws protecting banks, enacted at the time of withholding, remained in place even after withholding was repealed.

78. In 1991, an estimated DM 5.3 to 15 billion of revenue was lost as a result of nonpayment of taxes on interest income. See Kramer, supra note 73, at 855. According to estimates accepted by the Federal Constitutional Court in 1991, between 60% and 70% of domestic interest received by private investors was not reported. See Ault & Arnold, supra note 63, at 67.

79. See Kramer, supra note 73, at 855.

80. See Kramer, supra note 73, at 855; Richard G. Minor, Pending Legislation: German Parliament Committee Compromises on New Interest Withholding Tax Bill, 5 Tax Notes Int'l 63, 63-64 (July 13, 1992).

81. See Kramer, supra note 73, at 855; Neuman, supra note 63, at 309.

invalidate the tax, but rather directed the legislature to cure the defect by enacting compliance measures by January 1, 1993, in order to prevent the tax from being struck down.[82]

The Court prescribed two alternative enforcement approaches for the legislature to consider: information reporting and withholding.[83] The administration initially proposed a withholding tax of 25%, along with significant exemptions and exceptions that would have resulted in only about 20% of German interest recipients being subject to withholding.[84] The administration's proposal was approved by one parliamentary chamber but the other, controlled by the opposition party – the Social Democrats – rejected it.[85] The Social Democrats took the position that the proposal was constitutionally inadequate, and that only a reporting requirement would be sufficient.[86] They proposed to amend the bank secrecy laws to allow tax authorities access to bank records of German taxpayers.[87] The compromise ultimately agreed upon by the joint legislative conference committee was a somewhat more rigorous withholding tax.[88]

As part of its compromise with the opposition party, the ruling coalition made a commitment to re-examine its interpretation of bank secrecy laws restricting the tax authorities' access to account information by the end of the year.[89]

Effective January 1, 1993, the new withholding tax, at a rate of 30%, was introduced. The tax incorporates many of the exceptions and limitations of the originally proposed tax: The tax applies to interest received by German residents, but those who have interest income below a threshold exemption amount can have the withholding requirement waived.[90] Non-residents are not subject to withholding. In addition, foreign branches of

82. See Kramer, supra note 73, at 855.
83. See Minor, supra note 80, at 64.
84. Id.
85. Id.
86. Id.
87. Id.
88. Id. at 63.
89. See id. It appears that the promised ruling was never issued.
90. As under the administration's original proposal, the exempt amount was increased 10-fold from the prior law amount, to DM 6,000 for an individual, and DM 12,000 for a married couple filing jointly. See id. at 64. As of 2004, the exemption amount was € 1,370. See Ault & Arnold, supra note 63, at 67. German taxpayers with interest income below the exemption amount are not subject to withholding if they provide an exemption form to the withholding agent. The tax authorities are authorized to gain access to account information to ensure that a taxpayer does not claim multiple exemptions for multiple bank accounts. See Minor, supra note 80, at 64.

German banks are not required to withhold on interest payments made to German account holders.[91]

C. *Luxembourg*

Despite the limited scope of the withholding tax, taxpayers were concerned that in the future, the exemption amount might be increased or that German bank secrecy laws might be eroded.[92] As a result, there occurred again a capital outflow reminiscent of the 1989 experience, with an estimated DM 500 billion ($333 billion) moving from Germany primarily to branches of German banks in Luxembourg and Switzerland.[93] Amid reports of German citizens skulking around the streets of Luxembourg's banking district carrying plastic bags stuffed with deutschemarks, lured by full page ads proclaiming, "Luxembourg, the holiday home for your money,"[94] and "It's only a cat's leap away,"[95] setting up accounts using false names such as Helmut Kohl and Pinocchio,[96] the German government lost an estimated $15 billion in tax revenues during 1993 and 1994.[97]

In the ensuing years, the situation deteriorated further. The German government tried, unsuccessfully, through diplomatic channels to persuade Luxembourg to introduce a withholding tax and called for a Europe-wide withholding tax.[98] Luxembourg declined to act, pointing out that even if all European Union countries agreed to cooperate, Germans would continue to evade taxes by moving their money to non-EU countries such as Switzerland or Monaco, or to territories exempt from EU rules such as the Channel

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91. See Minor, supra note 80, at 64.

92. See Nathaniel C. Nash, Germans in Tax Revolt Embrace Luxembourg, N.Y. Times, Nov. 25, 1994.

93. See Ault & Arnold, supra note 63, at 67.

94. See John Eisenhammer, View from Frankfurt: Finding Unification in Luxembourg's Safe Haven, The Independent, Apr. 3, 1993.

95. See Greg Steinmetz, German Tax Collectors Rile Country's Banks with Aggressive Raids, Wall St. J. Dec. 4., 1996, at A1.

96. John Eisenhammer, Dresdner Denies Hand in Clients' Fraud, The Independent, Nov. 12, 1994.

97. See Nash, supra note 92. Estimates of capital moved and tax revenues lost vary, due to the evasive nature of the capital movement. See, e.g., Steinmetz, supra note 95 (citing an estimated $200 billion per year in capital moving out of Germany, and an estimated revenue loss of $15 billion per year); Greg Steinmetz, Tax Raids Tarnish Luxembourg's Luster as Jewel of International Banking Set, Wall St. J., June 14, 1996 (citing an estimated revenue loss or $10 billion per year).

98. See John Eisenhammer, Dresdner Protests Against "Bullying" Inspectors, The Independent, Jan. 26, 1994; Nash, supra note 92. (The German Finance Ministry also proposed that European countries require banks to share information about accounts holders with tax authorities.).

Islands or Gibraltar.[99] The remark of Luxembourg's Minister of Finance, Budget and Labor, Jean-Claude Juncker, captures the essence of the classic tax competition problem: "The money would leave within weeks [of an EU-wide agreement]. You would have to get European-wide cooperation, which is next to impossible."[100]

Desperate to stem the revenue loss, German tax authorities resorted to more aggressive tactics, staging about 50 raids against most major banks during 1995 and 1996.[101] In one raid, prosecutors sent 40 tax inspectors and finance experts to search the offices of Dresdner, Germany's second largest bank, for evidence of illegal money transfers, reportedly seizing incoming mail from Luxembourg and threatening to arrest uncooperative bank employees.[102] In another, 250 tax inspectors raided the Frankfurt headquarters of Germany's fourth largest bank, Commerzbank, seizing files and computer disks.[103] Ultimately, in 1998, even Deutsche Bank became a target, with 300 investigators swarming its headquarters and branches to search for evidence that bank executives collaborated with clients in illegal tax evasion.[104]

The banks fired back, claiming they were being "unjustifiably criminalized" in scare tactics aimed at German account holders.[105] Dresdner accused the government of leaking confidential information about investigations to the press.[106] Juergen Sarrazin, the chairman of Dresdner, went so far as to play the 'fascist card,' declaring "These are no longer the methods of a democratic state."[107]

In 1998, the German police made their first arrests in the investigations.[108] Ultimately, bank executives and clients were convicted of tax evasion.[109] Luxembourg's status as a premier international financial

99. See Nash, supra note 92.

100. See Eisenhammer, supra note 96.

101. See Steinmetz, supra note 95.

102. See Eisenhammer, supra note 96.

103. See Steinmetz, supra note 95.

104. See Edmund L. Andrews, Big German Bank is Raided in a Search for Tax Cheats, N.Y. Times, June 16, 1998.

105. See Steinmetz, supra note 95.

106. See id.

107. See id.

108. See A. Fisher, German Bank Staff Held in Tax Evasion Inquiry, Fin. Times, Jan. 4, 1996; D. Crossland, Police Make First Arrests in Dresdner Tax Probe, Reuters Eur. Bus. Rep., Jan. 3, 1996.

109. See e.g., Dresdner Tax Case Fines, Fin. Times, Aug. 14, 1996 (director of branch bank sentenced to DM 500,000 ($338,000) fine or four months in jail, and head of foreign department sentenced to DM 300,000 fine or one year in jail for helping a client evade taxes by transferring funds to Luxembourg); W. Munchau, Dresdner Client Jailed for Tax Evasion, Fin. Times, Feb. 13, 1996 (bank client, a

center suffered a decline.[110] But German taxpayers did not lose their taste for tax evasion, and German tax authorities did not lose their taste for aggressive investigations. The pattern of German evasion and enforcement established in Luxembourg played out even more sensationally in Liechtenstein, and the repercussions are still being felt.[111]

D. *Liechtenstein*

As is now widely known, Liechtenstein is a tiny principality (population: 35,000), located between Austria and Switzerland, that was famed for its bank secrecy laws. Liechtenstein has been at the center of a worldwide tax scandal that began in 2006, when the German foreign intelligence service, Bundesnachrichtendienst (BND), purchased secret customer information from a former employee of Liechtenstein Global Trust (LGT), a Liechtenstein bank.[112] The former employee, Heinrich Kieber, had first tried to blackmail Liechtenstein governmental authorities, demanding passports and free passage in exchange for keeping the information secret. (He was trying to evade criminal fraud charges in Spain.) Kieber then offered the information to tax authorities around the world, and the BND paid him $7.4 million. The BND turned the information over to German tax authorities, who used it to investigate hundreds of wealthy German citizens for failing to report income on deposits in Liechtenstein. Prosecutors raided homes and businesses of high-profile executives and celebrities, and investigated German banks who may have aided in the evasion. One prominent executive, Klaus Zumwinkel, the former CEO of Deutsche Post, has been convicted of tax evasion.[113] Many others came forward and confessed, and paid back taxes and fines, rather than face prosecution.[114]

55-year old dealer in sausage skins, sentenced to 45 months in jail and DM 1.3 million ($885,000) fine for evading DM 6.3 million in taxes using Luxembourg account).

110. See Suzanne McGee, Tax Inquiry Turns Banking Grayer in Luxembourg, Wall St. J., July 20, 1999; Steinmetz, supra note 97.

111. See infra notes 115-120 and accompanying text (describing the worldwide crackdown on tax evasion).

112. This account is drawn primarily from Randall Jackson's story summarizing major news developments in the Liechtenstein scandal. See Randall Jackson, The Mouse That Roared: Liechtenstein's Tax Mess, 49 Tax Notes Int'l 707 (Mar. 3, 2008). See also, Lynnley Browning, Banking Scandal Unfolds Like a Thriller, N.Y. Times, Aug. 15, 2008; Carter Dougherty & Mark Landler, Tax Scandal in Germany Fans Complaints of Inequity, N.Y. Times, Feb. 18, 2008.

113. See Randall Jackson, Former Deutsche Post CEO Convicted of Tax Evasion, 53 Tax Notes Int'l 393 (Feb. 2, 2009).

114. Derek Scally, German Authorities to Tell Revenue of Evaders, Irish Times, Feb. 27, 2008 (within two weeks of beginning investigation, German

German tax authorities shared the information they had received from Kieber freely with tax authorities elsewhere, prompting investigations in countries including the United Kingdom, Italy, France, the United States, Canada, Sweden, New Zealand, and Australia.[115] In many cases, the investigations expanded to include massive numbers of taxpayers.[116] In the United States, the Senate Permanent Subcommittee on Investigations held hearings and released a 115-page report on tax haven banks in July 2008, detailing offshore tax evasion by U.S. taxpayers in Liechtenstein and Switzerland.[117] In February 2009, Swiss bank UBS agreed to pay $780 million in fines and admitted that its employees had participated in a scheme to defraud the United States by helping U.S. taxpayers to set up offshore accounts.[118] In August 2009, the Justice Department's investigation of UBS resulted in a historic agreement by UBS to disclose the identity of 4,450 of its U.S. customers to the Internal Revenue Service.[119] By November 2009, nearly 15,000 additional U.S. taxpayers had come forward to disclose hidden offshore accounts pursuant to an amnesty program initiated by the IRS.[120]

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authorities raided 120 homes, 91 people confessed to tax evasion, and 72 people turned themselves in voluntarily).

115. Christian Retzlaff & Kim Murphy, IRS Searches for Hidden U.S. Assets in Liechtenstein Banks, L.A. Times, Feb. 27, 2008.

116. See Randall Jackson, Government Cracks Down on Tax Cheat, 55 Tax Notes Int'l 804 (Sept. 7, 2009) (French government investigating 3,000 French taxpayers with undeclared assets in Swiss bank accounts); Kristen A. Parillo, Tax Authorities Investigating Offshore Account Holders, 55 Tax Notes Int'l 612 (Aug. 24, 2009) (Italian government investigating up to 170,000 Italians with offshore accounts); Helen Power, HRMC Targets 60,000 More Britons in Offshore Account Probe, The Daily Telegraph, July 23, 2008 (British tax authorities investigating 400,000 British accountholders, discovering 100,000 suspected of tax evasion, with 40,000 voluntarily stepping forward and the remaining 60,000 under further investigation).

117. Staff of S. Comm. On Homeland Sec. & Gov. Aff., Perm. Subcomm. On Investigations, 110th Cong., Report on Tax Haven Banks and U.S. Tax Compliance (2008), available at http://hsgac.senate.gov/public/_files/071708PSI Report.pdf [hereinafter Tax Haven Report].

118. See Lynnley Browning, A Swiss Bank is Set to Open its Secret Files, N.Y. Times, Feb. 18, 2009.

119. See James Quinn, UBS Provides Customers' Names in US Tax Inquiry, The Daily Telegraph, Aug. 20, 2009.

120. See Lynnley Browning, 14,700 Americans Tell I.R.S. of Foreign Accounts, N.Y. Times (Nov. 18, 2009). Britain, France, Italy and Canada have instituted similar amnesty programs. See Coming Clean: Amnesty Offered for Tax Dodgers, The Globe and Mail (Canada), Oct. 29, 2009.

E. *The Court That Started It All*

Despite the shockwaves caused by its decision on interest withholding, the Constitutional Court does not appear to have been deterred from aggressive constitutional review of tax laws. In 2004, the Court again invalidated an inadequately enforced tax on investment income – this time a capital gains tax imposed on short-term gains from securities trading.[121] The statute did not provide for withholding or information reporting in collecting the tax, and for the years in question (1997 and 1998), the tax authorities had done little to enforce the tax through audits or other means.[122] The taxpayer challenging the tax, retired tax law professor Klaus Tipke, argued that because the tax was not enforced, it had the effect of imposing a greater tax burden on honest taxpayers, thereby violating the equality principle.[123] The Court agreed, and invalidated the tax for the years in question.[124] The unconstitutionality of the tax turned on both its lack of facial enforcement mechanisms, such as withholding or information reporting, and the lack of other meaningful enforcement activity. The Court's limited ruling implied that the tax's facial defects could have been cured by adequate enforcement efforts.[125]

In its decision, the Court sought to anticipate, and forestall, other challenges based on "unequal enforcement." It suggested that the capital gains tax, as applied to real estate, was less susceptible to avoidance and therefore valid. It also opined that even though independent contractor income is not subject to withholding (while wages paid to employees are), collection of the tax from independent contractors was adequately enforced through other means.[126]

In addition, there continues to be lingering concerns that the withholding tax on interest does not satisfy the equality in enforcement principle because its rate of 30% is less than the marginal rate of most taxpayers.[127]

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121. See Sirena J. Scales, High Court Holds Capital Gains Taxes Unconstitutional, 33 Tax Notes Int'l 963 (Mar. 15, 2004); Ordower, supra note 63, at 323-26. Under German law, longer-term gains from capital appreciation are generally not subject to tax. See Ault & Arnold, supra note 63, at 59.

122. See Ordower, supra note 63, at 324.

123. See Scales, supra note 121; Ordower, supra note 63, at 324-25.

124. See Ordower, supra note 63, at 325-26.

125. See id.

126. See id.

127. See Ault & Arnold, supra note 63, at 67.

V. THE CASE FOR INVESTMENT INCOME WITHHOLDING

The U.S. and German experiences with investment income withholding provide both normative and practical support for adopting investment income withholding in the United States.

A. *Equality in Enforcement*

Germany's "equality in tax enforcement" principle suggests that differences in enforcement effort are inherently unfair. This is not to say that the United States ought to import such a principle into its constitutional jurisprudence, and require withholding as a constitutional matter. The United States constitutional tradition is so different from Germany's that this is almost unimaginable.[128] Add to this the United States' ambivalence about consulting foreign law at all in constitutional matters,[129] and it becomes even clearer that a constitutionally-based argument for U.S. withholding would be futile. Rather, Germany's equality in enforcement principle legitimizes the fairness and equality as fundamental policy goals in designing and evaluating the enforcement mechanisms of any tax system.

This Article began with the claim that the U.S. system has tilted in favor of income from capital through explicit provisions of the tax law, and further, through differences in enforcement strategies. Withholding is the embodiment of this claim. Our failure to withhold from investment income – proven by our experience with wages to be highly effective – magnifies the explicit tax rate preference and other preferences enjoyed by investment income.

Whether investment income ought to be taxed more lightly than wage income is a contentious issue, and this Article does not attempt to reach a conclusion in that fraught debate.[130] Rather, it makes the more modest

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128. As comparative constitutional law scholar Professor Gerald Neuman observes, in discussing the German decision requiring withholding as a constitutional matter, "It would difficult even to articulate this successful argument as an equal protection claim in the United States." See Neuman, supra note 63, at 309. See generally Edward J. Eberle, Equality in Germany and the United States, 10 San Diego Int'l L. J. 63 (2008); Peter E. Quint, The Most Extraordinarily Powerful Court of Law in the World? Judicial Review in the United States and Germany, 65 Md. L. Rev. 152 (2006).

129. See generally, Daniel A. Farber, The Supreme Court, the Law of Nations, and Citations of Foreign Law: The Lessons of History, 95 Cal. L. Rev. 1335 (2007).

130. Compare Turnier, supra note 14, at 132-33 (income from capital and income from labor ought to be treated comparably), *and* Leslie Snyder, Taxation with an Attitude: Can We Rationalize the Distinction Between "Earned" and "Unearned" Income?, 18 Va. Tax Rev. 241, 298-99 (1998) (differing treatment of

argument – legitimized by the German equality in enforcement principle – that, whatever rate of tax is imposed, fairness demands that we use proven and effective tools to collect that tax.

B. *Practical and Political Considerations*

The U.S. past experience with dividend and interest withholding is instructive on two fronts. First, the 1982 legislation, along with the withholding laws of many other countries, can provide some basic design parameters for a new withholding proposal. Second, the 1982 experience gives us valuable predictive information about the resistance to be encountered – the groups who will likely lead the opposition and those likely to be enlisted, and the sorts of objections that will be made.[131] Donald C. Alexander, who served as IRS Commissioner in the Nixon administration (from 1973 to 1977), recently predicted (perhaps based on his personal experience with the 1982 law) there would be "ferocious resistance" by the financial services sector to any investment withholding proposal.[132] But forewarned is forearmed. We know that the principal argument historically made against investment income withholding was that it would be too costly and difficult to administer. This argument has become increasingly obsolete, to the point that it seems almost quaint. The same technological advances that made global tax evasion possible also make withholding cheap and easy to implement. Perhaps the best evidence of this can be found in the evolution

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earned income and investment income should be eliminated) *with* Eric M. Zolt, The Uneasy Case for Uniform Taxation, 16 Va. Tax Rev. 39, 77-80 (1996) (there may be efficiency and administrative reasons for taxing income from labor differently than income from capital).

The question of how to treat income from labor and income from capital is closely related to the even more contentious debate about whether it is better to tax income or consumption, which is beyond the scope of this Article. See, e.g., Joseph Bankman & David A. Weisbach, The Superiority of an Ideal Consumption Tax over an Ideal Income Tax, 58 Stan. L. Rev. 1413, 1420-1422 (2006) (summarizing three arguments in favor of taxing income); Daniel Shaviro, Beyond the Pro-Consumption Tax Consensus, 60 Stan. L. Rev. 745 (2007) (identifying a widespread consensus that consumption is the superior tax base, taking into account both efficiency and fairness, but arguing that when certain assumptions fail, there may be strong arguments for taxing savings).

131. Clearly, one major objection will be that investment income is subject to extensive information reporting requirements, which, theoretically, provides all the information the IRS needs to collect the tax on such income. However, it is well established that information reporting is less effective than withholding. See, e.g., George K. Yin, JCT Chief Discusses the Tax Gap, 107 Tax Notes 1449, 1452 (June 13, 2005).

132. Dustin Stamper, Budget Strain May Lead to Attack on Tax Gap, Former IRS Chiefs Say, 115 Tax Notes, 898, 898 (June 4, 2007).

of the payroll industry. When wage withholding was introduced in 1943, many employers used handwritten ledgers to keep track of employees' hours and wages, and paid their workers in cash.[133] The "cutting edge" technology of the time consisted of punch card machines and printed (as opposed to handwritten) data entries.[134] A major innovation was an I.B.M. machine that could prepare payrolls "in five copies, interleaved with one-time carbon paper."[135] Computers did not enter the scene until the late 1950s, with room-sized machines that read data key punch cards, and giant reels of magnetic storage tape.[136] Today, in contrast, complete payroll programs – that calculate state and federal tax withholding, prepare W-2 and other forms, print checks or perform direct deposits—are available for $200 or less.[137] Any small business owner with a home computer can withhold accurately and cheaply.

The German experience is a predictor of the new forms of objection the "ferocious resistance" is likely to take, and a training ground for critical evaluation of these objections. There will be howls of protest about capital flight, and its adverse impact on the domestic economy. But the German experience shows us that that capital flight was illusory – most of the funds moved into Luxembourg were reinvested in mark-denominated money-market mutual funds, thus immediately returning to the German economy.[138]

If capital flight is not the problem, then protests will focus on evasion, again pointing to Germany's dramatic drop in tax revenues upon the introduction of withholding. Opponents of withholding will sound like Luxembourg's finance minister explaining why his country's cooperation with Germany to stem evasion would be pointless: As long as there is a single country willing to exempt some U.S. investors and provide secrecy, they will argue, withholding taxes will be virtually impossible to collect, given the ever-increasing mobility of capital, combined with the avoidance genius of tax and finance experts.

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133. See Leonard A. Haug, The History of Payroll in the United States: The Evolution of the Profession and the Process From Colonial America through the End of the 20th Century 108-12 (2000). Ford Motor Company did not stop its practice of paying its 106,000 workers in cash until 1950. See id. at 141.

134. See id. at 129-30.

135. See id. at 133.

136. See id. at 145-48.

137. Galt Buying Guides, "Payroll Software Reviews and Buying Guide," available at http://www.galttech.com/research/software/payroll-software.php.

138. See Nash, supra note 92. Given United States' investors penchant for investing domestically even with today's globalized markets, even if the investors moved funds offshore, they would most like return to the U.S. economy, as happened in Germany in the 1990s. See Andrew Swiston, A Global View of the U.S. Investment Position, IMF Working Paper (2005) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=888050.

This coordination problem is the essence of the tax competition problem,[139] and indeed, the German experience with withholding is sometimes cited by academics as a cautionary tale about the dangers of tax competition.[140] Whether this proves true in the long run, however, remains to be seen. The German experience may instead turn out to be a tale about reaching the tipping point that led countries to engage in the cooperative behavior needed to overcome undesirable tax competition.

At the time of the events in Luxembourg described above, the Luxembourg finance minister's warning about the futility of cracking down on tax evasion seemed to ring true. Evasion had become widespread, as wealth holders from all over the world moved their money to tax havens to avoid home country taxes.[141] However, at the same time, countries began to undertake concerted efforts to combat tax evasion. In 1998, the Organization for Economic Cooperation and Development (the "OECD") issued a report identifying international tax evasion as a global problem, and proposing steps designed to rein it in.[142] The OECD has since made sustained effort to combat the tax haven problem.[143] In addition, in 2003, the European Union

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139. See generally Reuven S. Avi-Yonah, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 Harv. L. Rev. 1573 (2000); Julie Roin, Competition and Evasion: Another Perspective on International Tax Competition, 89 Geo. L. J. 543 (2001).

140. See Muten, supra note 75, at 745-46; Avi-Yonah, supra note 139, at 1583-84; Arthur J. Cockfield, Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation, 85 Minn. L. Rev. 1171, 1240 n. 244 (2001).

141. Estimates of the amounts held in offshore accounts have ranged from $5 to $11 trillion. See Tax Haven Report, supra note 117, n. 2. Offshore tax evasion had existed in the past, but the technological advances of the new millennium—by facilitating global mobility of capital – enabled it to run rampant. See Cynthia Blum, Sharing Bank Deposit Information with Other Countries: Should Tax Compliance or Privacy Claims Prevail?, 6 Fla. Tax Rev. 579, 590-92 (2004).

142 OECD, Harmful Tax Competition: An Emerging Global Issue (1998), available at http://www.oecd.org/dataoecd/33/0/1904176.pdf.

143. OECD, Toward Global Tax Cooperation: Progress in Identifying and Eliminating Harmful Tax Practices (2000); OECD, Improving Access to Bank for Information for Tax Purposes (2000); OECD, The 2001 Progress Report by the OECD's Project on Harmful Tax Practices (2001); OECD, Improving Access to Bank Information for Tax Purposes – The 2003 Progress Report (2003); OECD Centre for Tax Policy and Administration, The OECD's Project on Harmful Tax Practices: The 2004 Progress Report; OECD Centre for Tax Policy and Administration, Overview of the OECD's Work on Countering International Tax Evasion (2009).

The OECD's initiatives have received mixed reviews. See, e.g., Avi-Yonah, supra note 139; Karen B. Brown, Harmful Tax Competition: The OECD View, 32 GW J. Int'l L. & Econ. 311 (1999); Steven A. Dean, Philosopher Kings and (the "EU") adopted the EU Savings Directive, under which interest paid within the EU to individual residing in the EU is subject either to information exchange or withholding by the source country.[144] Several other information sharing and enforcement initiatives were also undertaken around the same time.[145]

The events of Liechtenstein have yet to play out in their entirety, but they have already prompted further progress in international cooperation, mostly in the form of increased information exchange.[146] While some commentators are skeptical about whether these efforts will deter evasion in the long run,[147] others are more sanguine.[148]

The ultimate lesson from the German experience may be that part of the solution to the international tax evasion problem lies at home – that a country must make a serious commitment to collect taxes from its own residents in order to elicit cooperation from other countries. By adopting withholding on domestic investment income, the United States could make just such a commitment.

International Tax: A New Approach to Tax Havens, Tax Flight, and International Tax Cooperation, 58 Hastings L.J. 911 (2007); J.C. Sharman, Havens in a Storm: The Struggle for Global Tax Regulation (2006).

144. Council Directive 2003/48/EC of June 3, 2003.

145. See Blum, supra note 141, at 597-603; Reuven S. Avi-Yonah, The OECD Harmful Tax Competition Report: A Retrospective After a Decade, 34 Brooklyn J. Int'l Law 783, 784-87 (2009).

146. See David Jolly, 2 Nations Agree to Ease Bank Secrecy Rules, N.Y. Times, Mar. 13, 2009 (Andorra and Liechtenstein agree to loosen bank secrecy rules); Graham Bowley, A Privileged World Begins to Give Up Its Secrets, N.Y. Times, Aug. 23, 2009; Charles Gnaedinger, OECD Empties Blacklist, 42 Countries Remain on Gray List, 54 Tax Notes Int'l 803 (June 8, 2009) (Andorra, Liechtenstein, Monaco removed from list of uncooperative tax havens); Financial Secrecy Jurisdictions Pledge Tax Cooperation, 2009 Worldwide Tax Daily 48-1 (Mar. 16, 2009) (jurisdictions including Switzerland, Luxembourg, Belgium, Andorra and Austria pledge to share information with foreign tax authorities).

147. See Lee A. Sheppard, Don't Ask Don't Tell Part 4: Ineffectual Information Sharing, 53 Tax Notes Int'l 1139 (Mar. 30, 2009).

148. See Avi-Yonah, supra note 145, at 783 (OECD effort against tax havens "a success").