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District Court Misapplies APA in *Florida Bankers Association*

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The D.C. district court recently upheld regulations that require U.S. banks to report to the IRS interest paid to nonresident aliens on accounts held in those banks. The purpose of this reporting requirement is to enable the United States to share this information with treaty partners. In upholding the regulations, the court incorrectly concluded that only would-be tax evaders would withdraw funds from U.S. banks in response to this reporting requirement. Smith argues it was unreasonable for the IRS to conclude that no funds would be withdrawn by NRAs simply out of fear that the information would be misused by their home country government. The fact that the IRS may reasonably believe the safeguards against that misuse are adequate does not justify its assumption that any NRA who is not attempting to avoid paying tax would share that belief.

The U.S. District Court for the District of Columbia recently upheld final regulations[1] that require U.S. banks to report deposit interest paid to nonresident aliens.[2] The regulations were challenged by the Florida Bankers Association and the Texas Bankers Association on the grounds that they were issued in violation of the arbitrary and capricious standard of the Administrative Procedure Act (APA)[3] and the requirements of the Regulatory Flexibility Act (RFA).[4]

As explained by the Supreme Court in *State Farm*, to satisfy the APA's arbitrary and capricious standard, ''the agency must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'''[5] Based on the agency's explanation of its reasoning, a reviewing court must determine whether the agency's decision ''was based on a consideration of the relevant factors and whether there has been a clear error of judgment.''[6] Under the RFA, an agency must consider the effect of its action on small businesses, consider alternative approaches that would minimize that effect,[7] and explain why any considered alternative was not adopted.[8]

Interest earned by NRAs on accounts in U.S. banks is not subject to taxation in the United States, and the IRS therefore has no direct interest in gathering this information. The IRS justified the reporting requirement as a necessity for the United States' compliance with its information-sharing treaties with various countries. The benefit to the United States from entering into those exchange treaties is the ability to obtain comparable information on offshore accounts held by U.S. taxpayers.

The bankers' associations warned that the information reporting requirement would cause some NRAs to withdraw funds from existing U.S. accounts — not to avoid paying tax on the interest income to their country of residence, but for fear that the foreign government would misuse the information. That so-called capital flight would hurt the banks subject to the reporting requirement and more generally hurt the U.S. economy as a whole, according to the associations.

The associations argued that the IRS, in deciding to impose the reporting requirement, had unreasonably concluded that the magnitude of capital flight would be minimal. This article asserts that the IRS's underlying reasoning was seriously flawed on at least one central point and that the reasoning used

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[1]T.D. 9584, 77 F.R. 23391.

[2]*Florida Bankers Association v. Department of Treasury*, No. 1:13-cv-00529 (D.D.C. 2014) (slip op.).

[3]5 U.S.C. section 706(2)(A) (''the reviewing court shall . . . hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law'').

[4]5 U.S.C. sections 601 to 612.

[5]*Motor Vehicle Manufacturers Association v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29, 43 (1983) (citations omitted).

[6]*Id.* (citations omitted).

[7]5 U.S.C. section 603(c).

[8]5 U.S.C. section 604(a)(5).

by the district court in upholding the IRS's conclusion was equally flawed.[9]

The IRS's determination that capital flight by NRAs other than tax evaders would be minimal was based on its view that there are adequate safeguards to prevent foreign governments from misusing the information shared by the IRS. The IRS reasoned that if NRAs with U.S. accounts understood and evaluated those safeguards, they too would conclude that the safeguards are adequate, and they would not withdraw their funds from U.S. banks. The district court held that the IRS was reasonable in this line of analysis.

Before explaining why both the IRS and the district court were wrong, it is appropriate to describe briefly the safeguards on which the Service relied. The IRS emphasized that the reporting requirement applies not to all NRA-held U.S. bank accounts but only to accounts held by NRAs whose country of residence has an information-sharing treaty with the United States. It is hard to see the force of this argument because even if the information had to be reported for all accounts held by NRAs, it would presumably be shared only with treaty partners.

The IRS also noted that all the treaties to which the United States is a party require that the information be treated and protected as secret by the foreign government.[10] However, the bankers' associations noted that the treaty partners include China, Egypt, Indonesia, Mexico, Pakistan, Panama, the Russian Federation, and Venezuela,[11] and that residents of those countries, for example, might reasonably fear their governments would not respect the treaty requirements.

The IRS argued that the United States will not enter into an information-sharing treaty with a foreign government unless the Service has determined that the country has strict confidentiality requirements.[12] Once again, the associations' illustrative list of treaty partners seemed to undercut the strength of this supposed safeguard.

Finally, the IRS asserted that even in the case of a treaty partner, it will not share information with that country if it determines that the country is not complying with the treaty's confidentiality requirements. However, this purported safeguard is self-refuting, because it ignores the effect on NRAs whose confidentiality has already been violated by the foreign government.

The IRS's reasoning is based on the flawed assumption that all NRA account holders would take the time and trouble, and have the sophistication, to understand and evaluate the Service's analysis of the safeguards. It seems much more reasonable to assume that most NRAs would lack the requisite time, inclination, or sophistication and would instead act on the basis of fear that their information might be misused.

A second problem with the IRS's reasoning is that it assumes those NRA account holders who did understand and evaluate the Service's analysis would agree that the safeguards are adequate. As noted above, there are clear and specific reasons why these safeguards do not seem as strong as the IRS apparently believes. Moreover, although a particular level of certainty may satisfy the IRS, it may not be enough to overcome NRA account holders' fear that shared information will be misused by their country of residence if funds are left in a U.S. account.

It may well be that for purposes of meeting the APA's arbitrary and capricious standard, it was reasonable for the IRS to conclude, as a legal matter, that the safeguards are adequate. However, it was unreasonable for the IRS to assume, as a factual matter, that most NRAs with U.S. bank accounts would agree with that conclusion. Likewise, it was improper for the district court to overlook the flawed premises on which the IRS based its conclusion that the magnitude of capital flight in response to the reporting requirement would likely be minimal.

As noted above, in *State Farm* the Supreme Court provided guidance on the nature of a court's inquiry in reviewing an agency decision under the arbitrary and capricious standard. The reviewing court must ask whether there has been a clear error of judgment in the agency's reasoning.[13] The flaws in the IRS's reasoning in concluding that capital flight would be minimal unquestionably constitute a clear error of judgment. There can be no doubt that flawed reasoning by an agency can represent a violation of the arbitrary and capricious standard.[14]

The IRS expressed its reasoning as follows:

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[9]This article elaborates on comments I made shortly after the decision was issued. *See* Jaime Arora, "Challenge to Nonresident Reporting Regs Fails," *Tax Notes*, Jan. 20, 2014, p. 256. This article is not intended as a comprehensive discussion of the district court's opinion but instead focuses only on a few aspects of that opinion. Consequently, it should not be assumed that I agree with the aspects of the opinion that are not discussed in this article.

[10]T.D. 9584, 77 F.R. 22392.

[11]Plaintiffs' Motion for Summary Judgment at 1, *Florida Bankers Association*, No. 1:13-cv-00529 (D.D.C. 2014).

[12]T.D. 9584, 77 F.R. 22392.

[13]463 U.S. at 43.

[14]*See, e.g., Center for Biological Diversity v. Department of the Interior*, 623 F.3d 633, 636, 641-643 (9th Cir. 2010) (flawed factual assumption made agency decision arbitrary and capricious).

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> The Treasury Department and the IRS believe that the legal and administrative safeguards described in the preceding paragraphs regarding the use of information collected under these regulations should adequately address the concerns identified by the comments and, therefore, these regulations should not significantly impact the investment and savings decisions of the vast majority of nonresidents who are aware of and understand these safeguards and existing law and practice.[15]

The flaws in the IRS's reasoning are apparent. The IRS does not even claim to be making a generalization about the total universe of NRAs with U.S. bank accounts. Instead, it is making an assertion only about "nonresidents who are aware of and understand these safeguards and existing law and practice." As discussed above, it seems reasonable to conclude that most NRAs with U.S. bank accounts will in fact lack that awareness and understanding. Moreover, given the obvious weaknesses in the safeguards and the potential for serious harm to account holders, it was unreasonable for the IRS to assume that "the vast majority" of NRAs who are aware of and understand the safeguards would agree with the IRS that they are adequate to prevent the misuse of information by the foreign government.

The district court mistakenly accepted the IRS's flawed reasoning on this point. The opinion correctly notes that "the heart of the Bankers Associations' argument"[16] is the negative impact capital flight by NRAs would have on banks subject to the reporting requirement. However, the opinion mistakenly stated that "the Service *reasonably* concluded that the regulations will . . . not cause any rational actor — other than a tax evader — to withdraw his funds from U.S. accounts."[17]

In the section of the opinion giving a general description of the final regulations, the court quotes the complete statement from the preamble expressing the IRS's conclusion that funds would not be withdrawn by "the vast majority of nonresidents who are aware of and understand these safeguards and existing law and practice." However, in the section of the opinion addressing the capital flight argument, the court misleadingly truncates that quotation to say that the IRS "concluded that the 'regulations should not significantly impact the investment and savings decisions of the vast majority of non-residents.'"[18] As discussed above, the IRS did not say that the vast majority of NRAs would not withdraw their funds from U.S. banks, but rather that funds would not be withdrawn by "the vast majority of nonresidents *who are aware of and understand these safeguards and existing law and practice*" (emphasis added).

It is significant that the IRS did not say in the preamble to the final regulations that even if there were substantial capital flight, the decision to adopt the regulations would be unaffected. The IRS said instead that it was unnecessary to be concerned about capital flight because as a factual matter capital flight would be minimal. Because that conclusion was based on fundamentally flawed reasoning, the district court should have held that the issuance of the regulations violated the arbitrary and capricious standard.

The capital flight issue was also part of the associations' argument that the issuance of the regulations violated the RFA. The IRS did not perform a regulatory flexibility analysis for the regulations, as would otherwise have been required, because, in accordance with an RFA provision, it certified that "these regulations will not have a significant economic impact on a substantial number of small entities."[19]

While the IRS acknowledged that the regulations would *apply to* a substantial number of small businesses, it concluded that there would not be a significant economic impact on those businesses. The associations argued that the IRS erroneously ignored capital flight in determining that there would be no significant impact on small businesses.

The district court relied on its earlier conclusion in connection with the APA challenge that the IRS reasonably determined that capital flight would be minimal. As discussed above, both the IRS and the district court were mistaken on this point. However, citing D.C. Circuit case law, the district court also questioned whether an impact on regulated parties that is based on the response of parties who are not directly subject to the agency action is even relevant under the RFA.

The D.C. Circuit case law cited by the district court is not directly on point. It holds that small businesses that are not directly subject to the challenged agency action but are only indirectly affected by it are not protected by the RFA regarding the agency action and may not use the RFA as a basis to challenge it.[20] Instead, only small businesses that are directly subject to the agency action

[15]T.D. 9584, 77 F.R. 23393.

[16]Slip op. at 18.

[17]*Id.* at 1-2 (emphasis added).

[18]*Id.* at 18.

[19]T.D. 9584, 77 F.R. 23393-23394. *See* 5 U.S.C. section 605 (authorizing this certification).

[20]*See, e.g., Mid-Tex Electric Cooperative Inc. v. FERC*, 773 F.2d 327, 342 (D.C. Cir. 1985) (the RFA is "limited to small entities

(Footnote continued on next page.)

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may use the RFA in a challenge to that action. The case law does not deal with a situation in which small businesses that are directly affected by the agency action also are indirectly affected by the actions of third parties in response to the agency action.

Nevertheless, the district court was correct to question whether capital flight is relevant to the RFA challenge. While the references to a ''significant economic impact'' on small business in the certification provision and elsewhere in the RFA do not explicitly limit that impact to the economic burden of complying with the agency action, it seems reasonably clear that this is the only type of burden the RFA is concerned with. One of the cases holding that small businesses not directly affected by the agency action cannot use the RFA to challenge that action also makes clear in dicta that only the compliance burden is relevant under the RFA: ''The problem Congress stated it discerned was *the high cost* to small entities *of compliance* with uniform regulations.''[21] Thus, while the district court was incorrect regarding capital flight for purposes of the APA challenge, it was right about capital flight for purposes of the RFA challenge.

subject to the proposed regulation''); *Cement Kiln Recycling Coalition v. EPA*, 255 F.3d 855, 869 (D.C. Cir. 2001) (''this court has consistently rejected the contention that the RFA applies to small businesses indirectly affected by the regulation of other entities'').

[21]*Mid-Tex Electric*, 773 F.2d at 342 (emphasis added).

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