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How FATCA threatens to derail the American economy

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The US government should also waive FATCA's reporting requirements for foreign financial institutions.

With the enactment of the 2010 HIRE Act, Congress aimed to increase employment and increase its revenues by going after foreign accounts owned by Americans.

Unfortunately, the legislation doesn't draw a distinction between honest Americans living and working abroad, and those citizens who are indeed hiding tax revenues from the American government. The legislation, Foreign Account Tax Compliance Act (FATCA), requires that individuals report their accounts held overseas and that foreign financial institutions report to the IRS about their American clients.

FATCA burdens American individuals and businesses overseas, as well as the foreign banks that wish to service them.

The billion dollar question is whether the burden of FATCA will outweigh its benefits.

The potential for losses are great on both the individual and institutional side.

On the individual side, these regulations threaten to undermine the social contract that binds Americans to their homeland.

Extreme paperwork may make Americans living overseas reconsider maintaining their citizenship. This means that America won't benefit from the taxes from those people who give up their citizenship. With Social Security's worker base shrinking and other issues facing America, it would seem as if America would want to encourage compliance among its tax-base, and not make reporting onerous enough so leaving the system is a feasible alternative. I imagine that Congress did not intend to have Americans abroad renounce their citizenship as a consequence of FATCA.

While the IRS's desire to prevent US-based taxpayers from hiding large sums of income producing funds in offshore bank accounts is understandable, the current enacting of the law hurts millions of law-abiding Americans who, for whatever reasons, don't live and work on American soil.

In addition, the regulations are turning American citizens overseas into undesirables.

Bank doors and job opportunities are being denied to them because organizations don't want to subject themselves to American scrutiny.

Expat US citizens who fail to report and pay taxes on the income from the assets that they hold in foreign financial institutions may be subject to a severe penalty and prosecution.

Another unintended consequence of FATCA will be its impact on US businesses investing and operating overseas. It remains to be seen if additional regulation abroad will make it possible for American companies to open accounts at foreign institutions, and whether the American businesses will want to devote the extra time and money necessary to report their overseas investments.

The threat of disruptive reporting requirements (in addition to the already existing dual-taxation reports) might be the straw on the camel's back that will cause American firms to miss out on promising foreign investments. If American businesses stop growing and expanding, it is only a matter of time until this impact trickles down the economic ladder and affects the average American living and working in the mid-west. This implicit value destruction could be problematic for the US economy.

On the institutional side, the cost of becoming FATCA compliant may be prohibitive for some foreign institutions, and therefore they will divest from their American holdings. This lack of capital investment may be more detrimental to the American economy than any tax revenue generated by the plan. After all, a steady infusion of funds, particularly from global markets, is necessary for the American economy to continue to grow.

Although the Treasury Department claims that FATCA compliance is entirely voluntary for foreign banks, the stiff penalties that the law levies on institutions that ignore its requirements suggest otherwise.

Faced with the choice between paying to implement the new rules or divesting from US-based assets, smaller foreign banks that can't afford to shoulder these costs may choose the latter. After all, there are plenty of promising new markets in which to invest.

According to the US Bureau of Economic Analysis, total investment by non-US persons in American assets exceeds $20 trillion.

Indeed, the private equity group BlackRock released a report last year where it indicated that it expected many small and mediumsized foreign banks to divest from the United States in response to FATCA.

And then, there's the question of whether America can impose its demands on foreign institutions and force foreign governments to become its accomplice in its hunt for tax evasion. Extradition agreements are one matter, but forcing a bank to violate customer privacy issues is another matter entirely.

The full impact of FATCA remains to be seen. In all likelihood, the laws' effects will be widespread and highly detrimental.

Some independent analysts estimate that global banks will have to spend more than $8 billion in order to revamp their systems and become compliant with FATCA.

Fortunately, the US government can easily solve the problems posed by FATCA. It has the power to amend the rules to protect the rights of US citizens who wish to make targeted investments in overseas accounts and assets, and not infringe on the independence of foreign banks.

America should pursue tax evaders. But that has nothing to do with requiring expats to file additional tax forms in order to report on financial accounts abroad. After all, do you think tax evaders will comply with reporting requirements? Furthermore, the current forms require reporting of accounts held in institutions, but not cold cash: if you hoard foreign currency under your mattress, there's no place to report it on your FBAR or 8938. So it's not the money per se, the IRS wants to know about, but if you hold an account.

Because the United States taxes its citizens on worldwide income, it has the right to create filing requirements. It is another thing to require additional reporting on foreign accounts on top of filing income tax. Even in a FATCA-less world the IRS wouldn't lose revenue, since Americans abroad would still be obligated to file and pay via standard tax forms.

Consider this: the abolition of FATCA (and FBAR, too) might actually enable the IRS to downsize its staff, reduce its budget, and appear heroic in the eyes of Americans looking for a more fiscally responsible government.

The US government should also waive FATCA's reporting requirements for foreign financial institutions. The law should be changed to reflect its original purpose: prevent the use of so-called tax shelters. The IRS should work on its own to identify tax evasion and not require foreign banks to report to a government other than their own.

FATCA's demand on foreign financial institutions and American citizens alike may ultimately do more damage than good. Forget the fiscal cliff. Instead, it may be FATCA that derails the US economy in 2013.

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