The Foreign Account Tax Compliance Act's Unintended Consequences

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The Foreign Account Tax Compliance Act (FATCA) was passed in 2010 to crack down on tax evasion. This Act is an extremely important piece of legislation meant to prosecute and ultimately stop wealthy Americans from evading taxes. This study examines the inadvertent negative externality on millions of U.S. citizens living abroad who are now subject to new compliance requirements. They must now file IRS Form 8938, adding to their regulatory burden at tax time. Considering that FATCA goes into full effect in 2015, we applied a cost-benefit analysis to a hypothetical, average U.S. citizen living abroad with holdings at a bank. We found that this seemingly innocuous consequence of the Act does more harm than good for an average American abroad. This externality is quite significant when generalized to all U.S. citizens living abroad. The results indicate that FATCA is not equitable and places a heavy burden on U.S. citizens living overseas. The advisability of amending FATCA to specifically target tax evaders rather than all Americans who have foreign bank accounts is problematic, as there is no clear-cut way of identifying tax evaders that is not arbitrary and does not cause undue hardship for non-evaders. Alternatively, a system of residence-based taxation should replace the current citizenship-based taxation system.

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1. Introduction

Under U.S. tax law, citizens are required to report and pay taxes on income from all sources, regardless of residency. Concerned about the extent of international tax non- compliance, the U.S. Congress passed the Foreign Account Tax Compliance Act (FATCA) in 2010. This law is an important development in U.S. efforts to combat tax evasion by U.S. persons (citizens and resident aliens) holding accounts and other financial assets offshore. In the past few years, tax evasion and the use of tax havens have garnered considerable media attention and public criticism worldwide. Attention has centered on wealthy Americans, the purported targets of the Act. Considering that the wealthiest one percent of Americans control over 35% of total U.S. personal wealth, the attention and scrutiny this group has received is perhaps appropriate (Wolff, 2012). The Occupy Wall Street movement that made headlines in late 2011 highlighted the growing income inequality in the U.S. and the fact that the media and government focus more attention on the wealthiest one percent than on the lower99% (Dean 2012, p. 12).

FATCA's importance cannot be overstated; it constitutes sweeping legislation that will affect the global economic environment. Yet previous studies have focused only on wealthy tax evaders, rather than on the large number of expats who will feel its repercussions. This study aims to address FATCA's consequences for ordinary U.S. citizen living abroad, who are not the wealthy one percent of Americans but will now be subject to the new requirements.

The perspective that FATCA was enacted to prosecute the tax evaders in the wealthiest one percent of the population was recently validated by reports that British banking giant, HSBC, helped wealthy clients across the world evade hundreds of millions of dollars in taxes. The report describes ways in which the bank allegedly advised clients on strategies to avoid paying taxes in their home countries (Letzing, 2015).

It is important to note, however, that these revelations came to light not in response to regulations imposed by FATCA, but rather from documents leaked by a former HSBC employee turned whistleblower. The leak followed a well-publicized data theft in 2007, the details of which are only now being made public. HSBC apparently did not react quickly enough to tighten compliance with tax laws after governments started to investigate in 2010. Given the lurid details made public in 2015, one may wonder why there have been no prosecutions of the HSBC officers and clients.. Apparently, the IRS and U.S. Justice Department are taking a "pragmatic" approach to the HSBC files; where criminal prosecutions are costly and difficult, it is more expedient to offer tax evaders a brief window during which they can come clean and pay reduced, civil penalties (Economist, 2015). This brings the value of FATCA into question, since it was not a factor in exposing the HSBC tax evaders. Further, other factors indicate that FATCA may create unintended and perhaps onerous consequences for citizens living abroad.

The majority of published material on FATCA describes its effects on billionaires who may have money hidden in the Cayman Islands, Switzerland, Singapore, or other tax havens. Yet FATCA operates in a catchall way that targets not only the tax evaders who keep money in foreign accounts, but also ordinary U.S. citizens living and working abroad. The U.S. Department of State estimates the number of American citizens living overseas to be roughly 6.8 million; most are middle-class expatriates, not wealthy tax evaders. That is a sizeable number of taxpayers presumably not targeted, but who will nonetheless be caught in a catchall dragnet. American expats are now required to file a new form, Form 8938, the Statement of Specified Foreign Financial Assets. Quoting a tax preparer advising American expatriates, David Jolly of the New York Times reported that, "it compels every taxpayer to try to find a way that they're guilty of some kind of omission" (Jolly, 2012). By some estimates, failure to file Form 8938 exposes a taxpayer to a fine of $10,000 per year, if deemed a willful violation (IRS Annual Report to Congress, 2014).

We examine the impact of FATCA on ordinary U.S. citizen living abroad with a cost-benefit analysis and find that the cost of enforcement will exceed the revenue to the U.S. treasury. Using the U.S. Department of State's estimates, we extend the results of this analysis to all expats and argue that the negative externality caused by FATCA is onerous and merits attention. We conclude that the law should be amended to allow a residence-based taxation system to replace the current citizenship-based taxation system. If passed, the amended law would apply to citizens in residence inside the United States and not to citizens living and working abroad.

This study contributes to the existing literature by highlighting the impact of FATCA on American citizens living abroad, not merely high-income tax evaders. In this paper we present a cost benefit analysis of a hypothetical average taxpayer. The remainder of this paper is organized as follows:

1. The background and impetus for FATCA.
2. A summary of the key provisions of the Act.
3. A review of the tax literature, including tax policies of several advanced countries as regards overseas income of their citizens living abroad.
4. A cost-benefit analysis using a hypothetical case of a U.S. citizen living abroad with holdings at a foreign bank.
5. Summary findings, conclusion, and limitations.

2. FATCA Background

Following the financial crisis of 2008, public awareness of the activities of the money center banks and tax havens for the wealthy peaked. The Obama Administration subsequently took the initiative to crack down on tax cheats. With the negative press that the financial sector and the affluent received at this juncture, some form of legislation was needed to respond to public outrage. In 2008, the Swiss bank, UBS, became embroiled in a tax evasion controversy, as did the LGT Bank of Liechtenstein, Deutsche Bank, and several others. These scandals had one common denominator–they each involved assisting Americans to elude taxes by channeling funds into fraudulent tax shelters. It became evident to the Obama Administration and to Congress that this problem would be better addressed by preventative measures rather than with penalties after the fact. That is essentially how FATCA came about (Dizdarevic, 2011, p. 2969).

FATCA was passed in 2010 as a provision of the Hiring Incentives to Restore Employment (HIRE) Act, an act meant to stimulate job growth. FATCA was designed to offset the high costs of HIRE and recover federal tax revenue in the process (Nauheim and Cousin, 2013, p. 183; Michel, 2013, p. 52). This was to be accomplished through agreements between foreign financial institutions (FFIs) and the IRS to identify American account holders and to disclose their account information. U.S. taxpayers were also required to report information about offshore accounts and assets to the IRS. If either party - the foreign bank or the American depositor - failed to disclose such information to the IRS, they would be subject to respective penalties. The key provisions of FATCA take effect in 2015 with tax reporting for 2014 (Foreign account tax, 2014).

The debate leading to FATCA legislation was contentious. Some argued that the provisions were too burdensome on FFIs, especially on smaller banks that could not handle the additional compliance costs. Others maintained that FATCA could be used as a model for other nations' own tax enforcement, and that the U.S. had made an impressive first step in halting overseas tax evasion. Michel (2013) focuses on FATCA's efforts to cut down on tax evasion and to prosecute the wealthy citizens who engage in it; however, he does not address the effects of the Act on U.S. citizens living abroad.

3. Key Provisions of FATCA

Before FATCA even became law, U.S. taxpayers - including individuals, corporations, partnerships, trusts, and estates - were already required to file an FBAR report, The Report of Foreign Bank and Financial Accounts. Using documentation from the FBAR, individuals and corporations were required to disclose and pay tax on all of their worldwide income, including investment income, accumulated in financial accounts located overseas. Willfully failing to comply with these conditions could result in criminal prosecution under U.S. law, and the taxpayers at fault would be responsible for considerable civil money penalties. Unintentional failure to follow these requirements could result in the assessment of tax, interest, and penalties on the taxpayer (IRC Sec. 911, IRC Sec. 6662(b)(7)).

FATCA's major contributions to existing tax law are 1) the obligation it places on U.S. taxpayers to report additional information and 2) the obligations it places on foreign financial institutions (FFIs) that receive money from U.S. sources (IRC Sec. 1471-1474). FATCA requires individual U.S. taxpayers to report assets held in overseas accounts valued at more than $50,000 on Form 8938 and to file that form with Form 1040. For bona fide overseas residents the exemption rises to $200,000 for single filers. These threshold double when a tax return is filed jointly with a spouse. All investment assets are subject to reporting requirements. These include financial accounts with FFIs, both custodial and deposit accounts, any securities or stocks held separately from a bank account or other financial account, foreign mutual funds, hedge funds, and partnership interests, and any life insurance issued overseas, including annuity contracts. These are what the IRS calls the "Specified Foreign Financial Assets." Given the variety of investments that fall in the reportable category, the $50,000 threshold (or even 200k) threshold is easily met.

Form 8938 seeks more detailed information than FinCEN Form 114, which has long been required of U.S. citizens with certain foreign accounts. Form 8938 is a three-page document that requires considerable time, resources, and effort to complete. FATCA defines FFIs as foreign entities that take deposits in the typical course of banking, hold financial assets for others' accounts as a large portion of their business, or are involved chiefly in the areas of investing, reinvesting, or trading in securities, partnership interests, commodities, or other financial instruments (IRC Sec. 1471(d)(4)-(5)). Fundamentally, FATCA defines FFIs as any entity that bears a resemblance to a bank or comparable financial establishment. Further, FFIs must enter into a disclosure agreement with the IRS or be subject to a 30% withholding fee on any U.S.–source investment income and U.S.–source proceeds from the sale of various types of property (IRC Sec. 1471(b)(1)(D)). To avoid this tax burden, an FFI is required to:

1. Acquire the necessary information to ascertain which of its accounts U.S. taxpayers hold.
2. Annually report information about all of its U.S. taxpayer accounts.
3. Deduct and withhold 30% of select payments made to recalcitrant account holders (those who do not provide sufficient information to resolve whether or not the account is held by a U.S. taxpayer) or for U.S. account holders who do not offer their name, address, and taxpayer identification number (TIN).
4. Obey IRS requests. If the FFI's local government forbids the reporting of such information, the FFI must receive a waiver of that prohibition or close the related U.S. taxpayer account (IRC Sec. 1471(b)).

In summary, FATCA imposes new requirements on FEIs in terms of new registration, due diligence, information reporting, and tax withholding obligations.

With FATCA in mind, the U.S. Department of the Treasury has also published models for intergovernmental agreements (IGAs). These will enforce FATCA's legal provisions in pacts between the U.S. and foreign countries. (Nauheim and Cousin, 2013). There are two basic models for these IGAs, each comprising sub-models. Under Model 1, FFIs in the partnering country report information about U.S. citizens' accounts and assets to their own taxing authority, which then divulges that information to the IRS. One version of this is Model 1A, in which the U.S. would also share information about the foreign country's taxpayers who hold accounts and assets in the U.S. The other rendering of this is Model 1B in which no such reciprocal arrangement is present. Under Model 2, FFIs report directly to the IRS, and the partner country also agrees to remove legal barriers to this reporting. One version of this is Model 2A, in which no Tax Information Exchange Agreement (TIEA) or Double Tax Convention (DTC) is required, while the other adaptation, Model 2B, is for countries with a pre-existing TIEA or DTC. Currently, 24 countries have signed an IGA with the U.S. and more are expected to do so (U.S. Department of the Treasury, 2014). So far, U.S. has secured more than 110 intergovernmental agreements, either signed or agreed in substance, to implement the law (IRS press release IR-2015-01).

To facilitate the reporting of information by foreign financial institutions, the IRS has built the International Data Exchange Service (IDES). Unveiled in January 2015, IDES provides the infrastructure for information exchange, presumably with necessary safeguards. Host country banks and tax authorities will use this service to report financial information on U.S. account holders. Participation in this program so far seems widespread, as "more than 145,000 financial institutions have registered through the IRS FATCA Registration System" (IRS press release IR-2015-01). IDES is supposed to be a secure web-based application of "automated, standardized information exchanges among government tax authorities" (IRS press release IR-2015-01). However, recent reports of hacking at the IRS and the private sector does not inspire confidence that any government or private sector agency can adequately protect confidential data. Data protection remains a high-risk concern.

4. Review Of Literature

FATCA has been examined in a wide array of literature. Michel (2013) summarizes FATCA's tax provisions and analyzes the reporting requirements of the Act. He contends that FATCA targets U.S. taxpayers who have not appropriately reported their foreign financial accounts and select other non-U.S. assets. Michel (2013) suggests that the intent of the act is not as much about collecting taxes as it is about pressuring FFIs and other entities to uncover U.S. account holders who are not complying with U.S. tax law and compelling them to provide information about those accounts on an annual basis.

Packman and Rivero (2010) contend that FATCA was initiated primarily to offset the costs of the HIRE bill by generating revenue. FATCA's potential effect on U.S. taxpayers with foreign accounts and assets is immense. The costs of reporting their foreign activities to the IRS will increase, added disclosures will be required, the penalties for foreign noncompliance will be larger, and the statute of limitations for an IRS audit of taxpayers will double. According to Packman and Rivero (2010), FATCA's impact will be broader than its influence on tax evaders in that the Act will affect all U.S. taxpayers with foreign holdings.

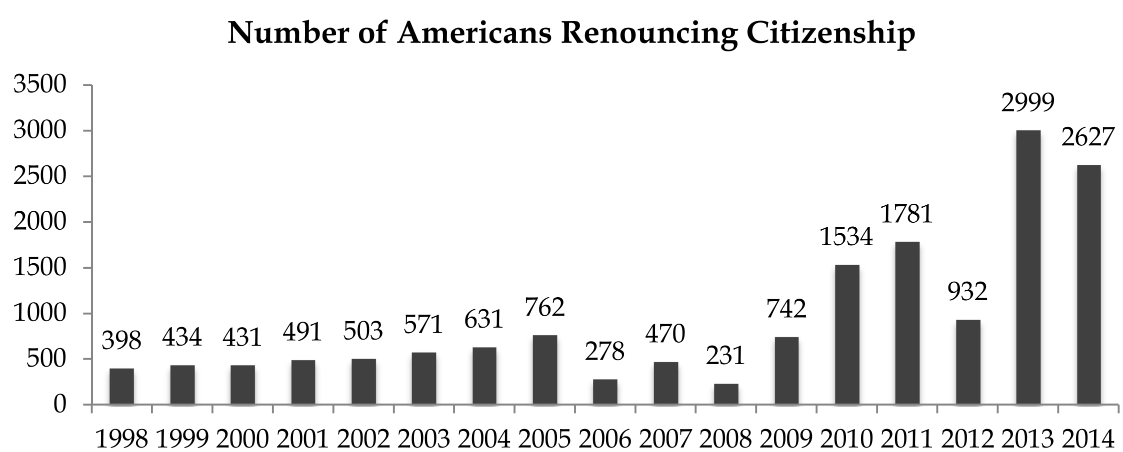
FACTA is a divisive piece of legislation that has been met with strong reactions, both positive and negative. Grinberg (2012) presents FATCA in a positive light, describing it as a positive step toward improved international information reporting and a key measure in ensuring that states have the means to tax offshore accounts. For Grinberg, FATCA will serve as a framework for an international system in which financial institutions cooperate to properly tax residents' overseas accounts or collect taxes from citizens with offshore holdings. Moreover Grinberg (2012) does not address FATCA's effects on U.S. citizens living overseas.

Zalan (2012) also stresses FATCA's value in recovering revenue from tax evaders, suggesting that somewhere between $21 trillion and $32 trillion in financial assets are hidden offshore. The author calculates that if only a three percent return were recovered on these assets, the increase in annual tax revenue would amount to between $190 billion and $280 billion. A global industry to avoid taxation is growing, and it will take a serious effort in order to deter this practice. Like Grinberg (2012), Zalan (2012) neglects to address FATCA's influence on middle-income American citizens living abroad and instead focuses on wealthy tax dodgers.

Rademacher and Moore (2012) offer a divergent perspective and argue that financial regulators have gone too far. They maintain that FATCA places an extremely heavy burden on foreign financial institutions. The authors stress that many FFIs have disallowed U.S. citizens from having holdings, since these institutions do not want to deal with the additional work associated with having them as clients. They further observe that FATCA regulations will leave U.S. citizens living abroad with fewer options for housing their assets.

Hinchberger (2012) observes that for foreign banks in countries that have signed IGAs with the U.S., failure to comply with FATCA reporting rules generates a penalty of up to a 30% on all of their U.S.–based transactions and those of their U.S. clients. Yet these FFIs have another option: to completely withdraw from U.S. markets and cut off business ties with American account holders. Several banks in Switzerland, Germany, France, Denmark, and Italy have done just that, leaving average American expatriates with few options for investment or savings accounts.

There is also anecdotal evidence that suggests that many foreign banks are closing accounts held by U.S. clients and many others are refusing to even open accounts (Sarfo, 2014). Michael Fried, a lawyer familiar with complications caused by FATCA reports that "the number of accounts that are being closed are disproportionately falling on middle-class Americans. If you're wealthy, you'll find a way to keep that account open. If you're a regular guy, it'll be harder to get loans for business. There's nothing stopping an American living in Italy from opening a shop except for the fact that they can't open a bank account. Certainly FATCA wasn't intended to do that for normal middle-class Americans" (Sarfo, 2014). Some argue that FATCA is responsible for increasing the number of Americans renouncing their citizenship (Stone 2015). Based on data from the U.S Treasury Internal Revenue Service Quarterly Publication of Individuals Who Have Chosen to Expatriate, the following chart shows that citizenship renunciations have risen sharply since 2009.



Similarly, Coggan (2012) offers a pessimistic outlook on FATCA. He theorizes that the costs of implementing the new tax rules will be exceedingly high, and that its breach of data privacy merits great concern. FFIs will be required to investigate whether their clients are U.S. citizens and then enter into reporting agreements with the IRS. Further, many hedge funds and other types of FFIs will be forced to rewrite their bylaws and restructure their rules. Compliance costs estimates on these institutions are predicted to be roughly $8 billion per year (Matthews 2012, Pomerleau 2014), which is nearly ten times the amount of tax revenue FATCA is expected to raise annually. Many countries pride themselves on providing privacy to their financial services industries by allowing secret bank accounts. As FATCA chips away at this secrecy, the nature of private financial arrangements is changing. Every FFI will be subject to the IRS's reach under FATCA, with no assurance of confidentiality. Coggan (2012) addresses several important concerns about FATCA, yet does not touch upon its significant effects on U.S. citizens living abroad. The majority of American expats, who are not engaged in tax evasion, must also comply with burdensome new requirements. In fact, the privacy concerns moved U.S. Senator Rand Paul to introduce a bill in the Senate to repeal FATCA in 2013 (Paul, 2014).

Alkan (2013) maintains that FATCA is an example of the U.S. going too far by extending its regulatory reach to the rest of the world; instead he maintains that extra-territorial laws should be used cautiously, if at all. The European Union has opposed similar extra-territorial legislation in the past on legal grounds. Alkan (2013) finds that the U.S. is the only advanced country that taxes those citizens who work and reside abroad on their foreign-earned income.

In summary, the likely benefits of the Act include the recovery of tax revenue and the ability to penalize tax cheats. Conversely, the frequently cited costs of the Act consist in its being a financial and administrative burden on FFIs and infringing on data privacy rights between FFIs and their honest account holders. An additional cost of FATCA that the majority of existing literature does not explicitly address is the Act's negative externality on average U.S. citizens living abroad. American expatriates are required to participate in new compliance under FATCA by filing Form 8938.

U.S. citizens living abroad will also have limited access to financial institutions, as several have disallowed U.S. citizens from having holdings (Rademacher and Moore, 2012). Considering that FATCA goes into full effect in 2015, the argued costs and benefits are at this point only educated conjecture. Nonetheless, in order to gauge the suitability of the Act certain assumptions must be made about the outcome of its implementation. Several studies have attempted to weigh the positives and negatives of the Act; all of them, however, focus on wealthy tax evaders, the Act's primary target group. Our study distinguishes itself by conducting a cost-benefit analysis that concentrates on the average U.S. taxpayer who lives abroad. By analyzing the positives and negatives surrounding the Act for this group, we can understand FATCA's impact in its current form on American expatriates.

5. Tax policies of G7 and BRIC countries

The G7, consisting of the U.S, Canada, France, Germany, Italy, Japan, and the United Kingdom, represent the older industrialized nations. The BRIC countries, consisting of Brazil, Russia, India, and China, represent the fast-growing emerging economies. Unlike the U.S., other advanced countries, including members of the G7 and the BRIC countries, do not tax their citizens' worldwide income when they are living abroad. By examining the tax policies of each of these countries and the nature and type of IGA each country has entered into with the U.S., it is possible to gauge FATCA's global reach. The following chart presents the policy positions of each country, compiled from information retrieved online from respective country's tax authorities:

G7 & BRIC Countries	Taxing Authority (and Source for each Country's Information)	Tax Citizens Living Overseas on Income?*	IGA with the United States?	Type of IGA Model	Date IGA Model was Signed**
United States	Internal Revenue Service	Yes	–	–	–
Canada	Canada Revenue Agency	No	Yes	1	02/05/2014
France	French Tax Administration	No	Yes	1	11/14/2013
Germany	Federal Central Tax Office	No	Yes	1	05/31/2013
Italy	Italian Revenue Agency	No	Yes	1	01/10/2014
Japan	National Tax Agency	No	Yes	2	06/11/2013
United Kingdom	HM Revenue and Customs	No	Yes	1	09/12/2012
Brazil	Receita Federal do Brazil	No	Yes	1	04/02/2014
Russia***	Federal Tax Service	No	No	–	–
India	Income Tax Department of India	No	Yes	1	04/11/2014
China****	State Administration of Taxation	No	No	–	–

* None of the above listed countries (apart from the U.S.) tax citizens who reside and earn a living overseas. Most of the above countries consider a citizen to reside in a foreign country if the citizen resides in that country for more than half of the year.

** The date that the IGA was signed, as listed in the table, should not be confused with the date that it goes into effect. Since the provisions of FATCA did not become active until 2015, the IGAs did not take effect until that date.

*** Russia is one of two countries that has not signed an IGA with the U.S. Russia has not ruled out the possibility of engaging in such an agreement, but it has publicly requested two stipulations: full reciprocity and an abandonment of U.S. extraterritoriality (Bykhovskaya, 2013, p. 1-2). Although Russia was until recently a member of the G8, its membership is currently suspended.
**** As of June of 2015 China has not signed an IGA with the U.S. China has expressed reservations about signing an IGA due to the increased burden it places on its financial institutions. Moreover because Hong Kong, a special administrative region of China, has recently signed an IGA with the U.S., while many mainland financial institutions are already working on FATCA projects, it is expected that China will sign an IGA in the near future (Chow, 2014).

6. Cost-Benefit Analysis: Case of A U.S. Expat Taxpayer

Estimates of the total cost of annual FATCA compliance on foreign banks vary widely, given that it is presently unclear how many countries and FFIs will be abide by FATCA regulations. Once implementation can be gauged in 2015, it will be possible to determine a more exact number of participating FFIs. Moreover, the additional revenue that FATCA would bring in cannot be estimated accurately since it is uncertain just how many U.S. tax dodgers are at large and how much income is being evaded (Zahid, 2012).

Given the limited knowledge available, attempting to provide a cost-benefit analysis of the Act on the entirety of actors involved is nearly impossible and would potentially yield misleading results. Yet, by analyzing the effects of the Act on a single U.S. citizen living and working abroad and then extrapolating the results, we can draw reliable and meaningful conclusions as to how the Act will impact the majority of American expatriates.

In order to conduct this cost-benefit analysis, a hypothetical bank will be named as an example of an FFI that is compelled to honor the requirements of FATCA. Since Canada is America's largest trading partner and information regarding its FFIs is readily available, we will locate, this theoretical bank in Canada (U.S. Department of Commerce, 2014). The account holder at the bank is assumed to be a middle class citizen of the U.S. who is residing in Canada for work and has a savings and brokerage account at the institution. The time period over which this study will take place is over the full year of 2015, the year FATCA is set to take full effect.

The first benefit (BENEFIT1) of FATCA included in the analysis is the tax revenue that would be recovered by the example FFI on an average U.S. citizen's account. This figure will be calculated based on the average account size at a Canadian bank, the average interest, dividends, and capital gains earned on an account at this type of institution, the percentage of average account holders who intentionally misstate their income on their U.S. federal tax returns, and the civil fraud penalty the IRS institutes on foreign earned income that has not been reported to the IRS by the taxpayer. The second factor, (BENEFIT2), included is the percentage of taxpayers not reporting honestly Lastly, the percentage of tax returns audited is included in the cost-benefit analysis.

As to the costs of FATCA, the first variable studied in the analysis is the financial and administrative burden (COST1) imposed on the example FFI, an FFI holding an account on behalf of a resident U.S. citizen. (COST1) is calculated by employing the independent variables of the additional hours spent in compliance and the hourly wage of the FFI's employees. This cost is one that could be passed along to account holders, as banks may choose to close the accounts of U.S. citizens rather than incur compliance costs. In consequence costs levied on FFIs are levied on U.S. taxpayers living abroad as well. The next cost of FATCA and variable (COST2), the administrative burden placed on U.S. citizens living abroad, is dependent upon the additional costs charged by tax preparers; (this study assumes a U.S. citizen living overseas would employ a trained tax professional due to the complex nature of his tax return.). The independent variables in this case are the additional hours the tax professional would have to work to complete Form 8938 and the average hourly wage of a trained tax preparer. The final cost of FATCA (COST3) defined in this analysis is the infringement of data privacy rights previously afforded to honest U.S. citizens living abroad. This is computed employing the independent variable of the right to privacy of a taxpayer who intends to report his income fully and truthfully. The procedures assumed to calculate each of these independent variables are explained in the proceeding section. Following this analysis of the affect of FATCA on a singular U.S. citizen living abroad with an account at a Canadian bank, the significant costs and marginal benefits on this person is extended to all U.S. citizens living abroad. This examination presents the costs that ordinary U.S. citizens living overseas must endure due to FATCA.

7. Cost-Benefit Analysis with A Hypothetical Taxpayer

BENEFIT$_1$

A_1 = Size of bank account; minimum threshold of $50,000 for single taxpayer with foreign bank account holdings that are subject to FATCA reporting requirements.

A_2 = ROI. The ROI for a basket of investments in Canada has hovered around 10% annually for the last fifty years or so (McFeat, 2012). This study assumes it will stay at 10% in 2015.

A_3 = Percentage of honest taxpayers. The percentage of American taxpayers who can be expected to honestly report their income and not attempt to commit fraud in this process is estimated to be 95%, according to a study on IRS audits (Hazard, 2003). That is, the amount of foreign earned income on interest, dividends, and capital gains that is not reported honestly by U.S. citizens abroad utilizing this bank is expected to be 5%.

A_4 = The civil fraud penalty percentage. The IRS institutes a civil fraud penalty of 75% on foreign earned income that has not been reported to the IRS by the taxpayer ("Foreign account tax," 2014).

BENEFIT$_2$

B_1 = Salary of an IRS auditor. An IRS auditor is typically the party charged with auditing a taxpayer and determining if he owes any additional taxes or is guilty of tax fraud. An IRS auditor who successfully audits and finds error or fraud in a tax return represents successful law enforcement. Under FATCA regulations, IRS auditors' work on the tax returns of U.S. citizens with foreign accounts and assets would be made significantly easier, since the FFI would disclose the information regarding the account holders. FFIs, therefore, would achieve the objectives of an IRS audit. For their occupation, IRS auditors are paid roughly $50,000 per year ("Accounting, budget and finance," 2014).

B_2 = Percentage of taxpayers not reporting honestly. If 95% of U.S. citizens with an account in the FFI report their income honestly, 5% do not. With this, 5% of the law enforcement efforts on behalf of the FFI, completing similar work as an IRS auditor, would yield results.

B_3 = Percentage of tax returns audited. IRS audits only about 1% of the people who file a Form 1040 (Francis, 2012). As such, the efforts of an audit can be portrayed as $50,000*.05*.01, or $25. With the implementation of FATCA, law abiding U.S. citizens abroad would be contributing to a moral victory in participating in the new regulation in order to stop tax evaders. This contribution is similar to that which an IRS auditor currently provides; hence it is valued at $25.

COST$_1$

X_1 = Number of hours per week on observance of law. In a survey conducted by Reuters, the majority of banks responded that their compliance teams spend roughly four hours per week on observance of law (Hamond, 2013). FATCA would add a significant burden to these compliance teams and could add roughly 25% of their current workload to their hours spent on compliance (Semenov, 2012, p. 24-35). This would equate to one additional hour per week spent by banks, or 52 additional hours per year. As the average Canadian bank has roughly 5,000 account holders, this would result in approximately .01 (52 divided by 5,000) additional hours spent on compliance per account holder.

X_2 = Average salary of a bank compliance officer. According to Census data, the average salary of a bank compliance officer is $65,000 per year, or $31.25/hour. It would likely take a team of three of these compliance officers to ensure proper following of all laws for an FFI throughout the year (Semenov, 2012, p. 24-35). X_2= $31.25*3, or $93.75 for the entire bank. This figure divided by the 5000 account holders at the institution equates to $0.02 per account holder.

COST$_2$

Y_1 = A tax professional would have to file a Form 8938 as well as an informational return for the taxpayer under FATCA. The IRS's estimated time burden for both of these forms together is about 2 hours (IRS 2014).

Y_2 = The type of tax professional assumed to be filing the taxes of a U.S. citizen with assets and an account in a Canadian FFI has an hourly wage of about $30 according to Census data, since it would take a fair amount of knowledge and experience to complete this type of tax return.

$COST_3$

Z_1 = An honest and law-abiding middle class citizen should be afforded the right to privacy. This is defended by the fourth amendment, which protects U.S. citizens from unreasonable searches of the person and possessions (Murphy, 2013, p. 485). A U.S. citizen living abroad who is not engaging in criminal acts and is reporting their taxes truthfully does not deserve wrongful persecution on account of those who are choosing to evade taxes. A data breach of a U.S. citizen's private information typically costs that person an average of $188 (2013 Cost of Data Breach Study: Global Analysis, 2013). The illegitimate compromise of a citizen's data is comparable to the legitimate compromise of data demanded by FATCA of American expatriates. In light of this, the study values the right to privacy at $188 per person.

BENEFITS	COSTS
$BENEFIT_1$: $A_1*A_2*(1-A_3)*A_4$	$COST_1$: X_1*X_2
$BENEFIT_1$: $50,000*0.10*(1-0.95)*0.75	$COST_1$: .01*$.02
$BENEFIT_1$: $187.5	$COST_1$: $0.0002
$BENEFIT_2$: $B_1*B_2*B_3$	$COST_2$: Y_1*Y_2
$BENEFIT_2$: $50,000*.05*.01	$COST_2$: 2*$30
$BENEFIT_2$: $25	$COST_2$: $60
	$COST_3$: Z_1
	$COST_3$: $188
TOTAL BENEFIT ON ONE PERSON: $212.5	TOTAL COST ON ONE PERSON: $248.01
TOTAL BENEFIT: $1,445,000,000	TOTAL COST: $1,686,468,000

8. Discussion, Conclusion And Limitations

The key finding from the hypothetical example is that the costs of FATCA exceed the benefits. The costs exceeded the benefits from a single taxpayer by $35.51. Further, when extending this figure to 6.8 million American citizens estimated to be living overseas (U.S. Department of State, 2013); the costs to this group in total exceed the benefits by $241,648,000. This constitutes a huge burden for a group of taxpayers who are not the main target of FATCA. This Act is meant to prosecute wealthy tax evaders who purposely underreport earnings on accounts held abroad; with its inception, it should accomplish this. Yet, as the example above shows, FATCA also impacts all U.S. citizens living abroad. These are middle-class citizens who properly report their income and who may experience significant negative externalities due to FATCA.

It is possible that the IRS is more likely to audit certain profile of individuals (e.g., extremely wealthy) for FATCA enforcement than it is to audit an average taxpayer.

For example, an IRS auditor only audits about 1% of the people who file Form 1040, as the benefits and costs of these audits are taken into consideration (Francis, 2012). However, selective or measured enforcement of the law is no panacea for the dragnet, catchall aspect of the law.

In the previous section, we listed tax policies of several other advanced countries as they apply to their citizens who reside overseas. While the U.S. taxes its expatriates, other advanced countries do not; i.e., the U.S. is the only advanced country to have a system of worldwide taxation as opposed to residence-based, or territorial taxation (Melot, 2004).

This study demonstrates that FATCA's costs for U.S. citizens living abroad outweigh its benefits. Although the Act may recover tax revenue and provide a moral victory in the penalization of tax cheats, the financial and administrative burden it places on U.S. citizens living abroad and the financial institutions they conduct business with far exceeds the benefits to the U.S treasury; this cost is further magnified by the act of infringing upon the data privacy rights of law-abiding American citizens. If FATCA's true intent is to prosecute wealthy Americans who may be evading U.S. taxes, then it should target only this group. With this perspective, FATCA can be viewed as an enforcement tool that creates a creditable threat of audit by its mere existence, so as to discourage tax evasion. It should not, however, persecute an average taxpayer family residing in Canada for employment reasons because that family meets the minimum threshold for FATCA compliance. To subject this taxpayer to added scrutiny because the taxpayer retained his/her U.S, citizenship can be seen as grossly unfair. The public policy dilemma of defining "wealthy" remains problematic; and any attempt to do so would be arbitrary.

FATCA will do more harm than good for this population. Although exact figures are not yet available, our simple illustration suggests that the costs may exceed benefits by millions (e.g., \$35.5 per expat x 6.8 million expats = \$241.1 million). Our illustration excludes the cost of technology infrastructure that the IRS developed for information sharing. In addition, there will be ongoing cost of maintaining this system, cost of tech support, the cost of added bureaucracy. These cost are likely to run into many millions of dollars.

The net costs of the Act are therefore damaging to the expatriate population - a group who keep funds in overseas accounts largely for convenience. While in theory, FATCA is an important regulation aimed at halting tax evasion and forcing tax cheats to disclose income, in practice, it is a blunt instrument with a far reaching, broad scope that affects all citizens. In sum, FATCA creates the following unintended consequences:

1. Cost of added bureaucracy for the US with little financial return. Strictly on a cost-benefit basis, FATCA is unlikely to be a revenue-positive undertaking, making support for the law untenable on a purely cost/benefit basis. The worldwide cost of FATCA implementation could reach billions of dollars, given the compliance costs to financial institutions.

2. Increasing number of "unbanked" Americans abroad. Foreign financial institutions are likely to turn away American clients, refusing them services, closing their accounts, or charging them higher fees to service their accounts.

3. Increased risk of filing errors due to confusion between the FBAR (Foreign Bank Account Report) Form 114 and FATCA Form 8938. This added complication may subject individuals to steep willful tax evasion penalties for simple reporting errors.

4. Dis-incentive to invest in US markets, as foreign ownership of US securities is subject to the same reporting and withholding penalties as those imposed upon Americans.

5. Ever more convoluted types of assets are likely to be used in the future to store wealth overseas.

6. Increased risk of identity and data theft as more and more personal data is being required for regulatory filings across borders.

A potential solution to the negative externality that FATCA places on U.S. citizens living abroad is that the U.S. move away from its current system of taxation to a residence-based taxation system. This would allow FATCA to target solely those U.S. citizens attempting to hide funds in tax havens as opposed to all U.S. citizens with foreign holdings; i.e., income earned abroad and savings by those living overseas would not be subject to U.S. taxes; only citizens living within the U.S. with overseas holdings would still be subject to FATCA. While FATCA legislation may be well intentioned, its specifics need attention and reform. By changing the U.S. tax system from that of worldwide taxation to the residence-based system, the high costs placed upon U.S. citizens living abroad would be alleviated.

There are obvious limitations to the analysis, which is based on a hypothetical case. Since FATCA does not fully take effect until 2015, the actual costs and benefits data arising from its use are not yet available. A major limitation is that we evaluate the effect of FATCA on a typical middle-class U.S. citizen living overseas and then extend the results to an estimate of the total population of U.S. citizens abroad who exceed the FATCA net worth threshold. Although extrapolating in this way is an issue, the figures and estimates do provide a sense of the scope of the financial burden involved. That the costs exceed the benefits allows the inference we reached earlier. Another limitation is that this paper involves a fair amount of theoretical rationale rather than definitive values for its variables.

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