The Foreign Tax Compliance Act – Is this the ultimate tax-sneeze?

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Abstract

The Foreign Account Tax Compliance Act (FATCA) is a United States federal law that requires all financial institutions outside the US to periodically report information about financial accounts held by US persons to the US Internal Revenue Service. The Government of Barbados, along with many other governments throughout the world, has agreed to its implementation. The objective of this paper is to determine the potential impact of this law on Barbados. The Analytic Hierarchy Process (AHP) is being used in this paper to conduct a cost benefit analysis of the potential impact.

The AHP is a structured technique for analysing complex decisions in situations where subjectivity plays an important role. The ability of the AHP to incorporate both tangible and intangible information into the analysis is an advantage for the analysis in this paper, because much of the necessary information is available only in intangible form.

With respect to implementation of the FATCA, there are two decision alternatives which are available; these are "to comply" and "not to comply". The stakeholders that are affected by its implementation are the Government of Barbados, the economy of Barbados, firms doing business in Barbados, citizens of Barbados, and US citizens residing in Barbados. The impacts on each of these stakeholders will be ascertained through the use of available quantitative data, interviews and questionnaires. The AHP will then be used to determine the benefit/cost ratio for each decision alternative.

The results of this research can be useful for any future re-negotiation of the agreement between the Government of Barbados and that of the USA.

Keywords: Macroeconomic policy, foreign tax, Analytic Hierarchy Process

1.0 Introduction

The Foreign Account Tax Compliance Act (FATCA) is an initiative by the United States to detect and deter United States citizen from using foreign entities to invest and avoid payment taxes on property. FATCA was enacted by the Hiring Incentives to Restore Employment (HIRE) Act on March 18, 2010. [2] The Act requires all non-United States (US) financial institutions to identify Americans in possession of financial accounts (banking, brokerage, etc.) in excess of US $50,000, and share that information with the tax authorities of the US. A foreign financial institution which fails to comply with FACTCA and does not enter into an agreement with the Internal Revenue Service (IRS) would incur a penalty on its capital flows from US source income and proceeds. [3] In essence, all relevant US-sourced payments, such as dividends and interest paid by US corporations, will be subject to a 30% withholding tax.[4]

FATCA was as a result of a "perfect storm" of world events, technological changes, the economic crisis and political pressure to curb offshore tax abuse [CITATION Mar13 \l 1033] . Existing law and administrative authority were insufficient to detect and deter offshore tax evasion by US citizens with offshore accounts. The Act addresses these deficiencies by empowering the IRS to identify US owners of foreign accounts and entities. The legislation allows the US the authority to ensure foreign financial intermediaries, which fail to disclose data on Americans, are cut-off from critical U.S. financial markets. As a result, foreign financial intermediaries including Barbados' have agreed to comply by reporting information on foreign accounts to the IRS.

The U.S. has reported estimated losses of $100 billion in tax revenues annually due to offshore tax abuses [CITATION Jon12 \l 1033] . It is argued that foreign financial institutions may be facilitating international tax evasion hence FATCA can combat tax evasion [CITATION Jon12 \l

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2 The Foreign Account Tax Compliance Act ("FATCA") was enacted under provisions of the Hiring Incentives to Restore Employment Act of 2010 (the "Act").

3 The IRS is the U.S. government agency responsible for tax collection and tax law enforcement

4 The term "withholdable payments" is defined to mean any payments of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensation, remuneration, emoluments, and other fixed or determinable annual or periodical gains, profits, income and gross proceeds from the sale of property that give rise to dividend or interest income, if such a payment is from sources within the United States.

1033]. Whilst the new Act (FATCA) is justifiably a worthy "perfect storm", because it protects the US tax base, curtails tax evasion and strengthens the transparency of international financial flows, there are concerns over implementation costs and benefits. The various costs associated with complying with FATCA may be disproportionately felt by foreign intermediaries. An institution with 25 million US accounts may incur an overall cost of $250 million to bring its accounts into compliances under the "Notice". Moreover, identification and documentation requirements for existing accounts will run at least several billion dollars [CITATION Ste10 \l 1033].[5]

It is without doubt, the implementation of FATCA constitutes a "tax-sneeze". The idea of a "tax-sneeze" is that FATCA which is a foreign corrective tax regulation inflicts a sudden involuntary expulsion of cost which irritates/inflates financial institution's expenditure and lead to the unintended consequence of lower benefits to the implementing agency (i.e. foreign financial intermediary). In essence, by imposing FATCA on Barbados, the Caribbean and the entire world the US has ultimately contributed to an increase in the financial intermediaries' expenditure. The extra costs to be incurred are not connected with creating additional value for FIs customers. The institution must meet the cost and this will be passed on to customers.

The Act is a complex tool which has attracted worldwide criticism, partly because of the necessary compliance, implementation and administrative costs for the adaptation of financial system may result in much higher numbers than the tax benefits of FATCA to be realized by the US tax authorities [CITATION Ali14 \l 1033] . Additionally, there is the issue of conflict of laws. In particular, for some countries adhering to FACTA might imply breaking the laws of their jurisdiction, specifically as it regards tax treaties and banking secrecy.

FATCA could also deter US citizens from undertaking financial investments in Barbados. The impact on citizens of the USA is only important to this study as far as the costs and benefits to Barbados are concerned. If the number of US citizens, who do business with the financial institution is small, then the cost of reporting may exceed the benefits of their business and the institution may prefer to exclude American citizens from among their customers. The New York

5 IRS Notice 2010-60 (the "Notice")

Times reported some middle class Americans living in foreign countries have lost their mortgages and bank accounts because of the burden imposed by the requirements of the FATCA on the banks [CITATION Stu15 \l 1033]. One consideration in the case of Barbados, where the number of American citizens is small, is that if the value of the business generated by them is less than the cost of meeting the requirements of the FATCA, then the additional cost will be passed on to other customers of the institution. The most direct impact on Barbadian citizens will result from the broad definition of a "US person". This term includes citizens of the USA, current and former green-card holders and people of other nationalities with various personal and economic ties to the USA [CITATION The15 \l 1033].

In a cost benefit sense, the impacts are on the financial institutions and individuals. Such impacts are the primary ones and include increased operating costs, and the psychological impact on individuals. There are also secondary impacts, which can be called risks and opportunities, because their occurrence is uncertain; these impacts are realized by the economy and individuals and include reduced foreign direct investment, reduced foreign exchange earnings, the closure of financial institutions, loss of employment, and loss of accounts by individuals. This research therefore investigates the aforementioned issues within the realm of Barbados to draw conclusion on "FATCA – Is this ultimate tax-sneeze". This crucial foreign tax imposed on our region creates unintended cost. How significant is this cost, what are the benefits and how should the region react? These questions are at the kernel of this research.

2. Literature Review

FATCA regulation cannot in practice be considered in isolation from the regulations of financial institutions. The costs and benefits (C&B) of financial regulation focus on the behavioral, market, general-equilibrium and political reactions and are particularly difficult to quantify or monetize. Many critics find that much financial regulation has little benefit and large costs. The main issues relate to the uncertainty of cost and benefit analysis (CBA) valuations, that is the difficulty posed by determining the valuations and the valuation difficulties associated with the nature of financial markets [CITATION IVJ15 \l 1033]. Similarly, others [CITATION Jef14 \l

1033] are of the view that CBA of financial regulations cannot work because financial markets are “constructed or artificial”.

On the opposing side, CBA can potentially mislead the public by omitting significant information about the uncertainty, judgment, and sensitivity of particular numerical results. These effects may be costly or beneficial by depending on one’s assumptions about the alignment of agency interests with public interests [CITATION Eri14 \l 1033].

In non-financial institutions, evaluating C&B of regulations of non-market goods such as life, health and biodiversity, have proven difficult to monetize with any degree of precision and confidence [CITATION IVJ15 \l 1033] . Agencies use feasibility analysis, which focuses on the technical capacity of private actors to comply with a proposed rule, rather than attempting to quantify the costs and benefits from implementing the rules [CITATION IVJ15 \l 1033] . Another alternative is risk analysis, in which the risk addressed by a rule is compared to risks that can be expected to arise as private actors respond to the rule. The measurement of externalities has proven difficult, in non-financial regulation, not only because these externalities are often non-market goods, but also because simply specifying and estimating their size is challenging.

Financial regulation poses equally, if not more difficult, problems in measuring externalities, in part because financial markets are tightly interconnected systems (hence the now mainstream phrase “systemic risk”), in which one party’s losses can be rapidly transmitted to multiple related parties [CITATION IVJ15 \l 1033].

In principle, the costs and benefits of regulation can be classified along two dimensions: a) if costs and benefits are direct or indirect and b) if costs and benefits are due to implementation of new regulation or due to compliance with existing regulation. Both distinctions are far from trivial, since they result in manifold allocation problems [CITATION Pan14 \l 1033].

a. *Benefit analysis and financial regulations*

The goal of the US government is to improve international tax compliance. Unlike many other jurisdictions, US tax liability is attached to citizenship or green-card holder status rather than residence, which implies that regardless of where US persons reside, they are liable to pay tax in the US [CITATION Ali14 \l 1033] . Second, the government's aim is to increase the ability of the US tax authorities to combat cross-border tax evasion by US nationals [CITATION Jan15 \l 1033]. Economists argue that when externalities are evident, correctives taxes are imminent [CITATION Keo98 \l 1033].

(b) ***Cost analysis and financial regulations***

Many jurisdictions are concerned that the cost of complying will exceed the potential benefit. Industry sources believe that overall private sector implementation costs could equal or exceed the amount that FATCA is projected to rise. [6] The direct costs can be seen as all costs necessary to develop, enact and supervise regulation. Whereas, indirect costs are all costs market participants and third parties have to incur, inclusive of opportunity costs [CITATION Fra97 \l 1033] . All other costs are understood to be indirect. Namely, labor costs of employees responsible for documentation requirements of a certain business line would be direct costs. In contrast, increased property expenditures which cannot be clearly assigned to a business line would be indirect costs.

Cost imposed by FATCA includes implementation cost (i.e. legal and advisory expenses for interpreting and communicating the new regulation to expenses for new IT systems) and compliance cost, that is, recurring costs of performing activities required by a regulation (i.e. expenses for preparing reports for the regulator and opportunity costs). Implementation cost is a one-time cost that is required for making changes to conform to the requirements of a regulation [CITATION Ell98 \l 1033], whilst the other are ongoing cost.

There is no guarantee that financial intermediates will bear the incidence of the cost incurred. It is assumed that some of the cost would be passed on to customers. A firm aims to maximize profit hence it would continue to equate its marginal cost (i.e production cost) to its marginal

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6 *Foreign Account Reporting Requirements: IRS Needs to Further Develop Risk, Compliance, and Cost Plans* (Apr. 2012).

harm (i.e compliance cost). It is therefore most likely that it would pass the cost onto consumers because of the risk of non-compliance.

A non-compliant financial intermediary risks being fined by the US. Specifically, the US will withhold payment of capital from that foreign financial intermediary (FII). Additionally, the compliant FII would be required to withhold payments from nonparticipating foreign financial institutions in cases where the funding for those payments could be attributed to "passthru payments" [CITATION Ita13 \l 1033].[7] Participating foreign financial institutions are therefore required to consider whether they would stop doing business with non-participating financial institutions. Countries are forced to comply with FATCA, with the threat of losing not only US investors but other businesses from those institutions which have agreed to comply.

3. Methodology

Financial regulations primarily involve social costs and social benefits. Hence, cost benefit analysis (CBA) is often used to evaluate the usefulness of such regulations. Cost benefit analysis quantifies the social costs and social benefits that will result from a regulation. If the social benefits exceed the social costs, the project is undertaken; it is not undertaken, otherwise. When there is more than one alternative available, CBA can be used to evaluate the costs and benefits of each alternative and the one that yields the highest net benefit is chosen.

Cost benefit analysis is based on the assumption that monetary values can be assigned to all costs and benefits. However, it may not be always possible or appropriate to assign monetary values to costs and benefits and in such cases the analytic hierarchy process provides an alternative.

Overview of AHP

The analytic hierarchy process (AHP) is a multi-criteria decision making methodology that is applicable in situations of decision making where there is certainty. The AHP has been applied in several diverse areas and, since its introduction in the 1970s by Thomas Saaty. It has become

7 Passthru payment includes any payment that can be withheld and any other payment to the extent it is attributable to a payment that has been withhold.

one of the most widely used multi-criteria decision making methodologies [[CITATION Saa90 \l 1033] and [CITATION Omk06 \l 1033]].

When applying the AHP, one starts by defining the problem under investigation. At this stage, it is necessary to identify the overall objective. In the case of the problem under consideration in this paper, the overall objective is to determine the costs and benefits to Barbados from implementing the FATCA. Next one must carefully determine the participants involved in the decision making process, since the accuracy of the results depends crucially on them. This is followed by structuring the decision problem, which requires that it be arranged in a hierarchy by dividing it into a number of smaller and less complex problems, which makes it easier to analyse (See [CITATION MMa12 \l 1033] . The evaluation step is the final stage of the AHP. This entails evaluating the alternatives, evaluating the criteria and prioritizing the alternatives. It may also be necessary to conduct a sensitivity analysis in order to take uncertainty into consideration [see [CITATION Saa12 \l 1033]].

AHP: Benefit Cost Analysis

In many situations, where the AHP has been applied, there are both benefits and costs associated with the decision alternatives [CITATION KUO04 \l 1033] . In such situations, there may also be uncertainty about the costs and benefits or whether there are intangible factors, which make it difficult to calculate the costs and benefits in monetary terms. The AHP allows one to incorporate uncertainty and intangible factors without the need for monetary values, and it thus provides the necessary information for making a sound decision [see [CITATION Die07 \l 1033]].

When the decision alternatives have both costs and benefits associated with them, it is customary to construct separate costs and benefits hierarchies, when using the AHP. By utilizing this procedure, one obtains a costs priority vector and a benefits priority vector and by taking the ratio of the benefit priority to the cost priority for each alternative, one obtains the benefit/cost vector. The decision alternative which yields the highest benefit cost ratio is chosen as the preferred alternative [see [CITATION Die07 \l 1033] and [CITATION Saa12 \l 1033]]. The principal criticism of using AHP to conduct cost benefit analysis is based on the use of two different hierarchies. These hierarchies lead to priorities which are based on different ratio scales and which may not be related. Furthermore, the benefit/cost ratio that is derived by using these two ratio scales does not bear any clear relationship to the individual ratio scales and it may therefore be meaningless [see [CITATION Die071 \l 1033].

Some authors have also included risk in the denominator of the benefits/costs ratio. This therefore requires the introduction of a third hierarchy for risk. Priorities obtained from these three hierarchies are used to calculate a Benefit ratio [CITATION Saa12 \l 1033]:

$$Benefit\ ratio = \frac{Benefit}{Cost * Risk} \qquad \text{(Equation 1)}$$

It is possible to introduce an opportunities hierarchy which would allow for the calculation of Opportunity ratio [see [CITATION Saa12 \l 1033]]:

$$Benefit\ Opportunity\ Ratio = \frac{benefit \times opportunity}{cost \times risk} \qquad \text{(Equation 2)}$$

Both Equation 1 and 2 have been criticized also. One criticism is that the product of costs and risks is neither meaningful nor justified and furthermore, differences in relative importance are not accounted for [see [CITATION Die071 \l 1033] . Similar arguments can also me made against BOCR analysis. Wijnmalen (2007), demonstrates that if the magnitudes of the benefits, opportunities, costs and risks are not measured on the same scale, then the results of a BOCR analysis can be meaningless and contradictory and can result in bad decisions [CITATION Die071 \l 1033] .

Model Formulation

Overall objective

The overall objective of the model is to determine whether or not Barbados should comply with the FATCA. Whether or not Barbados complies with the FATCA, there will be resulting costs and benefits. This paper therefore seeks to identify such costs and benefits and quantify them, thus enabling the relevant authorities to make an informed decision on compliance. In this regard, two hierarchies have been constructed, one of which is associated with the worthwhileness of complying and the other worthwhileness of not complying. The worthwhileness is taken to be the total benefit relative to the total cost. The decision on whether or not to comply is based on a comparison of the cost benefit ratios of the two alternatives.

Criteria

The criteria for evaluating the alternatives are political, economic, financial, administrative, social and psychological.

Political

The political factors relate to the effect of the decision of the Government of Barbados on the political relationship between Barbados and the USA. [8] This relationship is asymmetric, with the USA being the dominant partner and consequently, there are potential risks costs associated with failure to comply.

Impact on the economy

The economic consequences of the FATCA stem from its potential impact on GDP, employment, foreign exchange earnings, Government revenue, and the balance of payments. Non-compliance with the FATCA can result in a reduction in investment in Barbados by US firms and US persons, as a result of the associated penalties. Furthermore, it may lead to divestment by such entities. This study assumes that the principal sectors of the economy where there are investments by US entities are travel and tourism, finance, and real estate.

Tourism is one of the most important sectors of the economy in terms of its contribution to GDP, foreign exchange earnings and employment. In 2014, this industry accounted for 11.4% of real GDP. In 2014, approximately 73,000 persons were directly employed in the tourism industry, which accounted for 10% of the total the labour force. [9] In addition, tourism indirectly accounts for a large percentage of employment in other sectors of the economy. There are also investments by US entities in real estate in Barbados and there is a strong link between real estate development and the construction industry. In 2014, an estimated 12,000 persons were employed

8 This has been omitted from the criteria being considered.

9 Source: http://www.bhta.org/index/programmes/s-t-e-p/students-corner.html

in the construction industry the equivalent of 8% of the labour force. [10] The real estate industry is also one of the principal areas of foreign direct investment, which is one of the country's main sources of foreign exchange. Consequently, given the importance of tourism and construction to the economy and the role played by US entities in these industries, there is a risk that non-compliance with the FATCA can result in a reduction in GDP, which in turn, will result in reduction in Government tax revenue.

Another consideration is the impact of non-compliance on Barbados' offshore financial industry, which is very important to the Barbados economy from the point of view of foreign exchange generation and employment. Furthermore, from time to time, some members of the OECD accuse Barbados of being a tax haven; consequently, failure to comply could strengthen this claim and lead to sanctions being placed on its off-shore financial industry. This consideration, along with non-compliance itself, can combine to make the industry unattractive to investors.

Impact on financial institutions

Any bank or financial institution that does not comply with the FATCA is subject to a withholding tax of 30% on revenues generated in the USA. One problem that arises is determining what is classified as a financial institution for the purpose of the law [CITATION The15 \l 1033] and [CITATION Ste10 \l 1033].

The law may also impose a considerable administrative burden on non-US financial institutions, along with higher costs, commercial challenges, and legal, operational and regulatory risks. The European Banking Federation (EBF) and The Institute of International Bankers (IIB) expect that the cost of implementing the necessary customer identification and documentation will be very high for many financial institutions [CITATION Ste10 \l 1033] . In order to implement the requirements of the FATCA, financial institutions have to collect required information on all of their customers, whether or not they are citizens of the USA; therefore, for those institutions where US citizens comprise a miniscule percentage of the customers, the cost of collecting the information may be disproportionate to the benefit. The EBF and the IIB (2010) gives the example of Japan, where banks have a total of 790 million customer accounts, whereas US

10 Source: http://www.caribflame.com/barbados-unemployment-statistics-for-2014/

citizens that are resident in Japan account for only 0.04 % of the population and 2.4% of foreign nationals that are resident in Japan [CITATION Ste10 \l 1033].

Prioritization of criteria

In order to assess the impact of the FATCA, the following criteria were considered for prioritization.

- Information sharing between Barbados and USA
- Tax avoidance by Barbadians earning income overseas
- Investment in tourism
- Foreign direct investment in Barbados' real estate
- Demand for Barbados' financial assets
- Demand for Barbados' financial services
- Investment in Barbados' off-shore financial sector

The contributions of the relevant sectors to the economy were used to prioritize these criteria, along with the opinions of experts in the financial and tourism sectors.

Decision makers

The decision makers are the Government of Barbados, and financial firms doing business in Barbados. The Government has responsibility for ensuring compliance through its signing of the intergovernmental agreement. Financial firms may, however, choose not to hold accounts for US entities, to the extent that it is permissible in law.

Groups affected

The groups affected are the Government of Barbados, residents of Barbados, US citizens residing in Barbados, and firms doing business in Barbados. The financial sector of the economy will bear the direct impacts, while other sectors will experience indirect impacts.

Objectives

The Government of Barbados and private firms and residents pursue different objectives when responding to the FATCA. The Government is concerned with economic growth, employment, foreign exchange earnings, foreign investment, and domestic investment. Private firms will seek to minimize their operating costs and risk costs arising out of compliance with the FATCA.

Residents of Barbados, including US citizens, will seek to minimize the psychological and financial impact of the FATCA on their wellbeing.

Alternatives

There are two alternatives course of action, which are comply with the FATCA and do not comply with the FATCA.

Associated Costs and Benefits

There are two types of benefits that are associated with the FATCA. One is the direct benefit that arises from compliance or non-compliance; this benefit is certain. The other one is a future benefit that comes from opportunities arising out of the alternative taken; this is an expected benefit and is referred to as an "Opportunity". Similarly, there are two types of costs that are associated with the FATCA. One is the direct cost that arises from compliance or non-compliance; this cost is certain. The other one is a future cost that comes from risks associated with the alternative taken; this is an expected cost and is referred to as a risk cost. Prioritizations of the benefits and costs associated with implementation and non-implementation are given below.

Data Collection and Analysis

Experts in the financial and tourism sectors, and the Government, along with other people with relevant expertise, were asked to give their value judgments on the benefits relative to the costs (the worthwhileness) of complying or not complying with the FATCA, with respect to each of these prioritized criteria. These opinions were obtained through a questionnaire.

So far, responses to the questionnaire have not been good and, as a result, they have not yet been analysed. However, a preliminary analysis, using simplified criteria was done. The simplified criteria used are the costs and benefits of the FATCA to Tourism, Construction and Business and General Services. These categories were obtained from the GDP tables for Barbados and the weight for each criterion was determined from its contribution to real GDP, which gives an indication of its importance to the economy. It is assumed that the importance of foreign direct investment in real estate would be reflected in the contribution of construction to GDP. It was also assumed that the contributions of the demand for Barbados' financial assets and financial services and investment in the off-shore financial sector can be determined from the contribution of Business and General Services" to GDP. It is assumed that, for compliance and non-compliance, the benefits relative to the costs are equal for each of these criteria.

Results and Discussion

In spite of the simplification mentioned above, the results obtained are still relatively informative. The overall weight obtained for compliance is 0.5833 and for non-compliance it is 0.4167. Therefore, according to these results it is better to comply than not to comply. This result reflects the importance of the three sectors to the Barbados economy; together, they account for 38% of Barbados' GDP. It also reflects the dominance of the USA in the relationship between the two countries; or, stated differently, the high level of dependence of Barbados' economy.

There are a number of factors that need to be considered when interpreting these results and which will be investigated further.

The first is that the aggregate data used for the three criteria does not allow one to determine specifically the benefits and costs that are due to cooperation with the USA on the FATCA. For example, the category Business and General Services is used to capture the contribution of US entities to the financial sector; however, the majority of the contribution to this sector is generated by local businesses and service providers. Consequently, the weight of the US contribution is most likely to be considerably over stated. Future work on this paper will therefore seek to isolate the contribution of the USA so that a better informed decision on compliance can be made.

Another factor is that the analysis does not consider the political impact, on the relationship between the two countries, of the decision alternative chosen. The USA, because of its dominance, can impose various sanctions on Barbados for non-compliance and, even if Barbados may be better off by not complying, the costs of the risks associated with non-compliance may make compliance the preferred alternative.

The analysis does not consider i nformation sharing between Barbados and USA or tax avoidance by Barbadians earning income overseas. As far as information sharing is concerned, the relationship is asymmetric; therefore, the USA may withhold information from Barbados while demanding access to all information which is available to Barbados. This unfair sharing of information will affect Barbados' ability to prevent tax avoidance by Barbadian earning income in the USA.

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