This article appeared in ECI Developments Hemispheres Newsletter (www.ecidevelopment.com)

Have Exchange and Capital Controls Come to the United States?
by Joel M. Nagel

Long the champion and beneficiary of free trade and free capital flows, the United States has enacted recent legislation which a growing number of commentators and professionals believe could be the start of capital controls in America.

The provisions themselves are found in a Jobs' Bill – H.R. 2847 (also known as the HIRE ACT) which came into law this past March. Title V of the law (which largely encompasses the foreign account tax compliance ACT of 2009, or “FATCA”), referred to as the “Offset Provisions” of the Bill are designed on their face to force US tax compliance with regard to foreign accounts and transactions between the US and individuals in countries which are considered to be tax havens (meaning the banks and financial institutions in those countries do not share account information with US authorities). Section 1474 refers to “withholdable payments” to Foreign Financial Institutions that don't meet United States standards for information sharing. The law requires that any financial institution (US or foreign) remitting any foreign payment to a bank in such a country withhold 30 percent of the amount of such payment and remit that percentage to the Internal Revenue Service (IRS) as a tax.

A withholdable payment is defined as any payment of interest, dividends, rents, compensation, enumerations, emoluments, and other fixed or determinable annual or periodical gains, profits and income, if such payment is from sources within the United States.

On its surface, the withholdable payment is designed to ensure that “pre tax” monies are not sent abroad without proper tax being paid. Looking a little deeper however, the law does two things that go beyond the responsibility of each tax payer to pay what they owe to the IRS.

First, under section 1474 of the Bill, the law makes banks, as a third party, for the enforcement of tax policy. The banks are liable for the customer's tax obligation if there is not proper withholding. The banks are essentially the tax police, working for the government as hammers to bring about individual compliance.

Secondly, the same provision holds the banks harmless and indemnifies them if they improperly withhold the 30% tax and it is not due.

So, if banks are third party tax enforcers on the one hand, and completely indemnified from improper tax withholding on the other, then it is clear what banks will do. It will be difficult in any case for banks to determine the difference between a pre tax remittance versus a post tax payment. They will be inclined to simply withhold 30% tax on all foreign payments to banks and countries that do not have what are considered “information sharing” agreements with the United States.

The net effect of this provision will be to greatly discourage any financial transactions between US banks and foreign banks not entering into information sharing agreements with the United States Government. To wire transfer $100,000 to Panama, for example, to purchase a piece of real estate, one would have to agree to send $142,000 so that a net $100,000 would reach its destination. Who would be inclined or willing to pay 30% more in a global transaction in order to satisfy these requirements? Almost nobody.

International payments beginning January 1, 2013 will be subject to these new withholding requirements. The delay of over two years is designed to force foreign governments (especially those in tax havens) to enter into agreements with the United States. Secondly, it will put extreme pressure on individual foreign banks to enter into private sector agreements with the IRS to disclose all United States account holders or risk having all US transactions moving to their bank being charged a 30% remittance tax.

In addition to those intended effects, I believe the new law will have two unintended consequences as well. First, both US and non US persons fearing how the implementation of the new law will impact them after January 1, 2013, may be inclined to move assets outside the United States BEFORE the effective date, meaning we could see significant capital flight from the US in the next 26 months.

Foreign financial institutions may drop US clients as one way to avoid being subject to the 30% tax (again, probably an intended consequence of the law). Alternatively, foreign financial institutions and many foreign, private sector interests may simply stop conducting their business in dollars. A dollar denominated transaction will ultimately pass through a US Federal Reserve

Bank and potentially subject the transaction to the risk of a US bank levying a thirty percent withholding tax on any payment.

One method to ensure that this would not happen would b

e to designate the contract in a currency other than US dollars. If a German businessman, for example contracts with his Japanese counterpart to do a deal to sell equipment in China, the best way to ensure that the transaction would not be subject to US withholding tax would be to designate the contract in Euros, Yen, Won or any other currency than dollars. Those currencies would not pass through a US Federal Reserve Bank and therefore not become subject to the backup tax regime.

As more global transactions (especially oil, gold and other commodities) are done in non-dollar currencies, the global demand for the US dollar will decrease and it will no longer be the world's reserve currency. As demand decreases, the value of the dollar will surely fall as well. So while exchange and private capital controls may well have been envisioned in the HIRE ACT, additional unintended consequences of immediate capital flight and long term devaluing of our currency were probably less well considered.

It is unlikely that a new Congress in January 2011 or even a new President in January 2013 will undo the effects of this damaging legislation. For individuals, there exists just over two years to plan for the new law and take steps to avoid the consequences, both intended and unintended.

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EDITOR'S NOTE: See my article on Panamanian banks refusing US Clients: ***bit.ly/90fxgl***