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Financial Planning for Americans Overseas

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Last Updated: May 24, 2010

Globalization has not only moved many American jobs overseas but Americans, too. There can be real benefits to an overseas posting such as lower living costs and cheaper health care. Public records show more Americans are making permanent moves overseas and even forfeiting citizenship in increasing numbers. While taking up residency in other countries may help stretch a dollar, the principles of financial planning become exponentially more complicated and the decision should be carefully considered.

"The financial planning needs of overseas Americans are many and touch all areas of the financial planning process," says FPA member Jonathan Lachowitz, CFP®, owner of White Lighthouse Investment Management in Lausanne, Switzerland. Money management, retirement planning, income tax planning and estate planning still need to be addressed regardless of residency. According to FPA member David Kuenzi, CFP®, owner of Thun Financial in Madison, Wis., "These issues are compounded for Americans living abroad."

This additional complexity is driven by tax laws. There are local tax laws, U.S. tax laws, and tax laws dependent on treaties between countries that all affect aspects of financial planning. The difficulty in understanding and applying these laws is further compounded by the sheer magnitude of compliance. Passive foreign investment company (PFIC) rules affect almost all overseas investors and are particularly onerous. These rules allow the Internal Revenue Service (IRS) to indirectly generate tax revenues from investment companies not under U.S. taxing jurisdiction by taxing shareholders at higher than normal rates. According to Kuenzi, "The forms for disclosing these investments are estimated by the IRS to take up to 20 hours to file each year."

The IRS has little tolerance for mistakes on expatriate taxes; enforcement is strict and penalties are steep. But what is considered a mistake is not always as clear cut. "Some of the tax rules that apply to Americans living abroad are so convoluted that even the IRS does not have clear rulings," says Kuenzi. "If you ask ten different IRS employees a question about some of these laws, you will receive ten different answers."

"Taxes are a big issue," says Lachowitz. "Most U.S. tax advisers don't have the experience to properly prepare a U.S. tax return for an overseas client." FPA member Nick Hodges, CPA/PFS, MBA, CFP®, and president of NCH Wealth Advisors in Fullerton, Calif. agrees, "Tax planning for expatriates is a niche market and it is very easy to make mistakes. There are special situations that vary between countries; some rules are found only in treaties and are not readily apparent at first glance."

The simple decision to reduce taxable income by maxing out retirement plan contributions is a common tax planning tool, but for Americans overseas, this decision requires additional foresight and calculations. Some countries have attractive retirement plans that allow more contributions and larger matches than those in the U.S. but Americans are essentially penalized for contributing. Kuenzi explains, "Contributing to a tax-deferred account reduces your local taxable income and thus, your local tax bill. But when you have fewer local taxes to deduct from your U.S. return, your U.S. tax bill actually increases." Double taxation is a possibility for expatriates and requires careful planning to avoid.

"Americans overseas can contribute to a Roth Individual Retirement Account (Roth IRA), traditional IRA, Simplified Employee Pension IRA (SEP IRA), or 401(k)," says Kuenzi. Once again, the typical rules for financial planning can change when living overseas, as pointed out by Hodges. "An expatriate may have enough foreign earned income exclusion, housing exclusion, and foreign income tax credit that they don't have any taxable income and would not benefit by contributing to a U.S. retirement account." Hodges suggests an alternate solution, "In a situation like this one, investing in a U.S. variable annuity may be better; it would provide the same tax-deferred growth but, unlike the qualified account, funding the variable annuity would create basis."

Even investment selection requires knowledge of tax laws because a small misunderstanding can dramatically negate investment gains. Lachowitz explains, "If you bought two identical funds, one listed in the U.S. and one in Ireland, kept them for 10 years and the funds doubled in value, the U.S. fund would be subject to long-term capital gains rates and the gains in the Irish fund would end up getting taxed over 60 percent due to PFIC rules."

Investments listed in the U.S. generally provide lower taxes, stronger regulation, and more competitive fees than their counterparts listed abroad. But they can also expose an overseas investor to currency risks. "Understandably, Americans living abroad are concerned about being paid in another currency, spending in another currency, and having all their investments in the States in dollars," says Kuenzi. Fluctuations in currency can create gains taxable by the U.S. and needs to be considered in investment planning.

Where to house investments is another issue fraught with nuance. "If you live abroad, it is difficult to open an account in the U.S.; most firms in the U.S. will not open an account if your residency is outside the U.S.," explains Kuenzi. But the alternative has its own set of problems. "U.S. citizens find it difficult to open investment accounts overseas because most banks find compliance with IRS rules to be extremely burdensome," says Lachowitz. Kuenzi adds, "The compliance makes it almost too expensive for international banks to serve Americans living abroad."

Americans who have no intention of ever returning to the U.S. may attempt to simplify their situation by forfeiting citizenship. "Giving up your citizenship suddenly starts to make sense when you are wealthy," says Kuenzi. Hodges agrees, "I can see it making a difference when you are marrying a foreigner who is very wealthy and you don't want to risk the U.S. taxing your partner's wealth." But saving on U.S. taxes can be very expensive; forfeiting citizenship often involves paying a large sum in taxes. Kuenzi says, "From a purely financial perspective, people should give up their citizenship while they are poor, but that is rarely when it happens. This decision usually has a reason other than finances alone."

If you are seriously considering moving abroad, find expert advice, even if it means changing advisers. "Many countries have government representatives who are responsible for their overseas citizens," says Lachowitz. "But as a U.S. citizen living overseas, you are subject to taxation without much representation." Without a government advocate, even innocent mistakes can be costly and difficult to correct. A financial planner with experience in both the U.S. and your host country can act as an advocate for you on these complicated issues. To find such a qualified planner, consider asking other expatriates for a referral. Even with a referral, make sure your planner has credentials and licenses to work in both countries.

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