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Kings Of The Road

Providing cross-border financial planning for expats can be tricky.

By Jeff Schlegel

Living in another country can be an exotic adventure. That is, until it comes time to fuss with your finances. Figuring out what to do with your taxes, retirement plans, real estate and other monetary matters across multiple jurisdictions can be a confusing mess that, if mishandled, could result in serious financial missteps. Just ask Treasury Secretary Timothy Geithner (more on that later).

In some cases, common sense financial planning for traditional, U.S.-based clients can be the wrong advice for cross-border clients. For Americans moving to Canada, consider what could happen with living trusts, a common estate planning tool in the U.S. “These aren’t flow-through entities in Canada like they are in the U.S.,” says Brian Wruk, president of Transition Financial Advisors Group in Gilbert, Ariz., a firm that specializes in advising expats on both sides of the U.S.-Canadian border.

Wruk’s advice: Unwind the trust before relocating north of the border because all undistributed income is taxed at the highest marginal tax rate, which, depending on the jurisdiction, can be as much as 48%.

For financial advisors, that’s just one example of the vagaries and vicissitudes of planning for clients who live and work abroad. Planning for cross-border clients entails knowledge of the tax treaties and investment regulations of the country—or countries—where a person has financial interests such as earned income, property, a business or financial accounts.

“The [expat] landscape is laced with landmines that can blow up on you if you don’t know what you’re doing,” says Frank Reilly, president of Reilly Financial Advisors LLC in La Mesa, Calif., a firm that advises expats in 11 countries and has an office in Saudi Arabia. “There are so many moving pieces when somebody moves overseas.”

According to the IRS, as of 2006 roughly 7 million Americans filed tax returns outside the U.S. Lucrative pay is often a big incentive for taking an overseas gig. Missionaries or teachers in Africa, on the other hand, go abroad for other reasons. But no matter the pay, working overseas provides tax advantages thanks to the Foreign Earned Income Exclusion.

To be eligible, individuals need to be physically outside the U.S. for 330 days during a period of 12 consecutive months. In 2009, the first $91,400 earned overseas is tax-free for U.S. purposes. This applies to both employees and the self-employed, but they must file IRS Form 2555 to receive this benefit.

Sounds great, but expats still have to worry about taxes in the country where they live. They have to be careful about handling property they buy overseas. And they have to remember that Uncle Sam is always looking over their shoulder when it comes to worldwide income.

Kyra Morris, a certified financial planner in Mt. Pleasant, S.C., says that among her clients is a couple who recently moved back to the U.S. from Germany after living abroad for ten years. They bought a home there, kept it and turned it into a rental property.
“When I did their 2008 tax return, I noticed he didn’t give me income information on their German rental property,” Morris says.
“The guy said, ‘What’s in Germany should stay in Germany, and I shouldn’t have to report that.’ I said, ‘That’s not the way it works, and that we’ll attempt to get a tax credit for any taxes paid in Germany.’”

IRS Form 1116 is used for claiming foreign tax credits for taxes paid in foreign countries. Nick Hodges, president of NCH Wealth Advisors in Fullerton, Calif., says a common mistake in this area is that many foreign fees and excise taxes don’t qualify because they aren’t considered foreign income taxes.

“More developed countries such as the U.K., Sweden and even Mexico tend to have higher income taxes than in the U.S.,” Hodges says. “Less-developed countries tend not to have a strong income tax structure, so they tend to take their fees out in tariffs and other hidden types of fees. Africa, South America and Central America are famous for that.”

On Your Toes

There are numerous complex reporting forms that need to be tracked by U.S. citizens or residents with foreign accounts, depending on a person’s situation. For instance, there’s Form 5471 that applies to U.S. residents who own more than 50% of a foreign corporation. Wruk says the fine for not filing the form is $10,000, and that the IRS is increasingly vigilant on non-compliance.

Social Security taxes is another area that can trip up U.S. expats. Timothy Geithner’s confirmation hearings for the Treasury secretary post hit a snag when it became known he didn’t pay Social Security taxes on earned income from his consulting work with the World Bank.

“When work overseas isn’t connected to the U.S., there’s no facility for them [the employer] to withhold Social Security taxes,” Hodges says. “So that’s one that people tend to miss.”

Hodges notes that it’s important to have a clear understanding of an expat’s tax situation before making investment advice. “There are times when you’d make a recommendation to someone stateside that you wouldn’t to an expat because they wouldn’t have the same tax issues.”

One example is when an expat makes less than the Foreign Earned Income Exclusion, which results in no U.S. tax hit and negates the advantages of boosting 401(k) or IRA contributions. “Those could be the wrong investment vehicles in that situation,” Hodges says. “Rather than an IRA, in some cases they might be better off in some type of variable annuity product where they have basis.”

Getting Up To Speed

Holly Hunter found out firsthand the difficulties in dealing with cross-border finances. The Portsmouth, N.H.-based certified financial planner owns a rental property and a working ranch in Mexico. She had to set up her working ranch as a corporation, which came with assorted administrative headaches such as complying with stringent local labor laws and opening up a bank account (a specific visa is required) and filing frequent reports on that account to the Mexican government.

“I was clueless when I bought the properties,” Hunter says. “I was just looking at blue water and a beach. There’s so much you don’t think about until you’re in the middle of it.

“I’ve learned through the school of hard knocks over the past four years,” she adds. “I think more folks will be attracted to Mexico because living costs are lower there. It’s a great opportunity for retirees.”

To help clients who’ve moved to Mexico, Hunter taps into folks with in-depth knowledge of Mexico’s financial workings. Among them is Raoul Rodriguez Walters, founder of Mexico Advisor, a firm specializing in providing financial services to expats living in Mexico.

“You can provide a lot of value-add to clients by giving them the lay of the land before they move abroad,” he says.

Some advisors feel it’s necessary to turn to outside experts for help with expat clients. “I’m foundationally knowledgeable, but I try to find professionals who’ve developed a niche in this area,” Morris says. She adds that roughly one-fourth of her clients are expats who went abroad for work-related reasons.

She says it’s comparable in her regular practice to finding tax advisors and other professionals with niches in estate planning or other areas that aren’t her fortes. “There’s so much involved with all of these [expat-related] issues,” Morris says. “Each country is different because you have to look at tax treaties and other issues within each country.”

Morris says one place she goes for help is the Cross-Border Planning Alliance, a group of five advisory firms with specialties in cross-border financial advice. The group includes Wruk and Rodriguez, along with a certified financial planner in India.

“Advisors should find someone to assist them in this area,” says Wruk, an Alberta native who’s also a registered advisor in Canada. “All of these top people you might have lined up here in the U.S.—estate planning attorneys, accountants or investment managers—are totally irrelevant when you move to a foreign jurisdiction.

“If a client is moving to the U.K., you need someone who’s an expert in U.K.-U.S. tax treaties,” he continues. “If you manage money for someone who’s going to reside in the U.K. you have to ask what securities regulations you might be violating because you’re not registered to manage money over there. Even though the money is located here, you’re providing investment advice to a resident of another country, and you can’t do that without being registered there.”

One thing to consider, says Wruk, is whether E&O insurance coverage applies to advice provided to someone residing in a foreign country.

Anja Luesink, a New York City-based certified financial planner, believes that most advisors can adequately handle expat clients on their own if they create the right network and don’t extend themselves to jurisdictions beyond their knowledge and comfort zone.

Luesink has a number of foreign national clients from her native Holland who live in the U.S. “I try to attract clients from there because I’m aware of their circumstances,” she says. She also has foreign national clients from Canada and Great Britain. She says she’s built a network of specialists in those countries, such as tax advisors who are familiar with local tax issues.

“I wouldn’t take on clients in places I’m not familiar with, such as Mexico,” Luesink says. “You have to be very careful or you’ll make mistakes. But who else will do it? You have to start somewhere to build expertise.”

Keep It Simple

Nick Hodges, who works with advisors to handle the tax aspects of their expat clients, says the planning side can be greatly simplified by keeping the bulk of a client’s investments in the U.S. He does recommend setting up a local bank account in the client’s residing country, though.

And for clients who own overseas real estate or businesses, he notes that people who collect rents and have income from businesses with no operational ties to the U.S. can defer taxes on profits until the money is brought back to the U.S. But he notes this issue is being scrutinized by the Obama administration, and that significant revisions could be in the offing.

Despite the complexities of expat finances, Hodges says financial advisors shouldn’t shy away from handling such clients. “These people tend to be optimistic, are problem solvers and are generally adventurous,” he says. “From an advisor’s standpoint, they’re wonderful people to work with. But you have to know where your edges are so you don’t go beyond them and get them into trouble.”