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Planning opportunities for US expats: a mission critical introduction

In today's globalised world, the opportunities afforded Americans abroad have never been greater. However, significant care needs to be taken to ensure that any build-up of foreign cash does not get whittled away through poor tax structuring and financial planning. This article seeks first to explore and identify some of the issues, and second to review the planning opportunities to help overcome them. This is a must-read for any Americans considering a meaningful sabbatical in distant lands, or any expats who have already taken the plunge. The bad news is that the costs of making a misstep can be eye-watering, but the good news is that the actions to mitigate those costs are typically straightforward and inexpensive, provided the right advice is being sought from the right professionals in plenty of time.

The basic challenge all US expats face.

Let's start with the basics. Alongside Eritrea and North Korea, the US has a long history of taxing their citizens wherever they live in the world, rather than only those that are living at home. This is colloquially known as Citizen-Based-Taxation, rather than Residence-Based-Taxation. The quick and dirty is that any American citizen, wherever they are living in the world, with income above a de minimis level is without exception obliged to file US taxes on their worldwide income. The problem is that in most global regions, after an initial grace period, the US expat is also obliged to file local taxes on at least their local income, and often their worldwide income, too. Taxes are typically not payable twice, as many local regions have a double tax treaty with Uncle Sam; however, planning that is locally tax efficient is often wildly tax inefficient back in the US, or vice-versa. The unknowing expat can be caught between a rock and a hard place.

Working with an adviser: local versus US?

It is of utmost importance to select the right financial adviser to work with. They should specialise in working with locally based US expats and be able to demonstrate a firm understanding of the complexity surrounding tax compliance of differing investment structures to both tax regimes. They obviously need to be locally regulated, but in an ideal world would also be US regulated to future-proof the relationship against a potential return or retirement to the US. In our view, it is rare to find a US-regulated advisor with the right level of specialist knowledge, particularly one who is locally regulated in the region in question, which tends to be a requirement of the local regulator (e.g., such as the Securities and Futures Commission in Hong Kong). Consequently, we would recommend working with a local adviser, in the right time zone, but with the requisite specialist knowledge and who has also jumped through the hoops to be dual regulated.

Fees and taxes: where to custody the assets?

Local custody may seem like the logical solution and could be tempting from an administration perspective but in our view US custody may be the better option. It is commonly recognised that fees and taxes are the quickest way to erode away good investment performance. Let's start with the fees: in the US custody fees are, if not non-existent, certainly de minimis. At Raymond James US, for example custody fees are essentially zero, with transaction fees coming in at c $15 per trade for a mutual fund. This compares to non-US custody fees which typically start at c 15 basis points (0.15%) but can step up as high as 60 basis points (bps), with meaningful transaction fees on top.

Let's now think about the US tax regime. If electing to invest in funds (of which more below), and investing within a taxable account, it rarely makes sense to invest in a non-US mutual fund, otherwise known as a Passive Foreign Investment Companies (PFICs) from a US perspective. Long story short, PFICs are aggressively taxed in the US (either marked-to-market on an annual basis and subjected to a "dry" tax on unrealised gains each year; or the realised gains on eventual sale become subject to the highest rate of income tax, with additional interest applied to unpaid taxes from previous years).

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Without worrying too much about the gory details, holding non-US funds is generally a no-no for US taxpayers, but it can be challenging and expensive to hold US mutual funds in non-US custody accounts.

Finally, the cost of US mutual funds tends to be meaningfully cheaper than their non-US counterparts, albeit with similar underlying holdings. So, in conclusion, we believe US custody is generally the best strategy for taxable accounts that belong to US expats. Over multiple years, additional fees and taxes can have a huge impact.

Retirement accounts: local versus US?

We believe the job of a financial adviser is to discuss all available tax deferred or tax-free vehicles that are recognised both locally and back in the US. There are examples of tax-free vehicles that are not recognised in the US, for example MPFs, savings plans, or other local insurance wrappers, which probably do not make financial sense for an American living abroad. The MPF is compulsory for many Americans working under local contracts, so some inefficiencies are unavoidable. However, the good news is that some investment vehicles are recognised in both jurisdictions (such as certain foreign pensions), and (subject to liquidity constraints) should certainly be considered. So, the quick answer here is that we would recommend exploiting both local and US tax-deferred or tax-free wrappers wherever possible. This comes back to the need for specialist advice, where it is incumbent that your adviser understands the landscape in both jurisdictions, and as importantly how each jurisdiction considers savings and pension vehicles in the opposite jurisdiction.

Global diversification and currency considerations.

As noted above, the US has fairly draconian laws against investing in foreign (non US) funds due to the PFIC legislation. However, the legislation does not apply to individual stocks, which means a US expat could build up a portfolio of local stocks in their country of residence without getting beaten up by the IRS. However, in our view, while the tax problem is solved through a single stock portfolio, the diversification element is woefully lacking. We are always fearful of the "tax-tail wagging the investment dog", or in otherwise building an inefficient portfolio from an investment perspective which works from a tax perspective. We would recommend the priority is to focus on the investments, and then as a secondary concern work out how to ensure the investment solution is as tax efficient as possible both locally and in the US.

This brings me neatly onto currency considerations. In a perfect world, an investor would match the currency of their liabilities with the currency of their investments. So, for example, if resident in HK with predominately HKD liabilities, it would be ideal if the investments could also be HKD denominated. Unfortunately, if using funds as the building blocks of a portfolio, as we would strongly recommend for diversification reasons, the currency of the investment would need to be USD to avoid the PFIC issues described above. This can feel scary as there is a perception of a significant FX risk – what happens if the HKD becomes unpegged from the USD for example? For any holdings that are not only USD denominated, but also actual US assets on US soil, there is FX risk here, but that is no different to an HKD portfolio investing in US assets, bar some translation costs.

For any assets held elsewhere, for example in Europe, there is no GBP/USD FX risk per se, but a very real GBP/EUR risk, as there would be for a GBP denominated portfolio that was also investing in European assets. The point of the story here is that the dollar is simply a conduit for the investments, but the real FX risk is the currency of the underlying investments against the currency of the liabilities. Perceived wisdom is that the global diversification argument trumps the FX risk argument every time. To put it another way, the only option to dial out any FX risk would be to only invest in UK assets, which would obviously lead to huge concentration risk, as often discussed in arguments against the home-country bias.

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Married to a non-American?

Your husband or wife now enjoys the elegant title of Non-Resident-Alien (NRA) spouse, but if you can get over that, there are some potential advantages. It might make sense to keep the marital assets segregated, to avoid US reporting for the assets in your spouse's name. There is an annual allowance of $175k (2023) that can be gifted from the American spouse to the Non-American spouse which takes the assets permanently out of the IRS tax net, which has obvious advantages. As an example, in HK, the Principal Primary Residence benefits from zero Capital Gains Tax on sale. In the US there is an allowance ($250k if Married Filing Single – MFS), above which CGT is levied. In some instances, the allowance is unsatisfactory, which can come as a nasty shock. However, with sensible planning well ahead of any sale, the equity in the property can be gradually gifted to the NRA spouse at c$175k pa without eating into the US Lifetime Gifting Allowance.

The caveat to this type of planning is a consideration for local estate or inheritance tax laws, which are currently very favourable in the US. It would not make sense to gift all the assets outside of the US tax net, only for them to be aggressively taxed on death. Again, specialist inheritance and estate tax planning is required here.

Summary

There are great opportunities afforded to the US expat on the global stage, but significant care needs to be taken to manage personal finances. In our view, the most important first step is to seek advice from a specialist financial advisory firm that is 100% dedicated to the US expat audience. Their job will be to ensure no missteps are made, and to bring in specialist advice from accountants and lawyers as necessary. Provided you are working with the right team, it should be plain sailing from there.

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