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AARO 2020 Advocacy Survey Results Article 10: It's So Difficult to Save for Retirement!

Doris L. Speer July 5, 2021

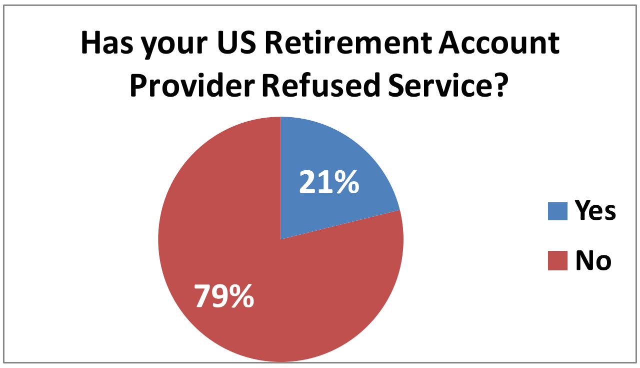
In previous articles, we addressed why many of you have found it so difficult to maintain retail and investment bank accounts in the US (No. 4) and retail bank accounts in your country of residence (No. 7). In this article, we focus on your difficulties with defined contribution retirement accounts in both the US and in your country of residence.

We step through the issues through the eyes of an American in mid career who wishes to move overseas to work for a non-US employer. Our hypothetical potential expat wonders how this move would affect her retirement planning.

US Retirement Accounts

Service can be refused, amounts will be lower

The first question our American expat has is whether she could maintain her current US 401(k) and IRA accounts, and count on them sufficing at retirement. The answer is "maybe, maybe not."



Many of our survey respondents (21%) have told us that the institution holding their US retirement accounts (such as a 401(k), IRA or other tax sheltered account) had liquidated or threatened to liquidate the account, or placed restrictions on the account. One of you "*had to liquidate retirement accounts inherited from my mother because of my foreign address.*" Another said "*Fidelity client since 1978. Have US address, but when they found out I had a foreign address as well, they massively restricted my account which meant I had to move my IRA elsewhere. This* *was in 2013.*" Our expat needs to be prepared for the possibility that her financial institution may force liquidation of, or restrict. her IRA account at some point.

A significant number of our survey respondents (79%) do manage to maintain their US retirement accounts. But many could be subject to minimum balances and/or higher fees to do so. Further, they cannot build them up because one generally loses the ability to make contributions to US retirement plans while working overseas.

- 401(k) plans are sponsored by employers. One either has to be working for a US company that offers a 401(k) or be self-employed and set up a solo 401(k) oneself. Since our expat will no longer have a US employer, she will not be able to contribute any longer to her 401(k)

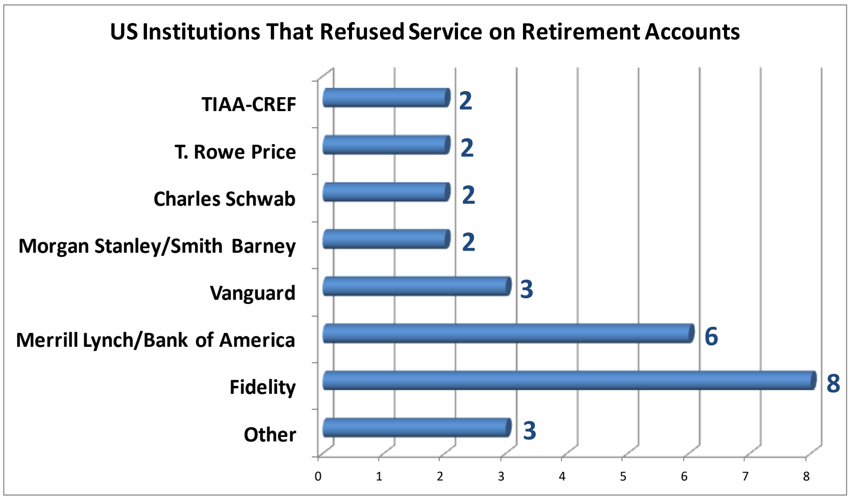
- In order to contribute to an IRA while living abroad, one needs to have income leftover after deductions and application of the foreign earned income exclusion (FEIE). If our American expat excludes all her income with the FEIE she cannot contribute any longer to her IRA

So, our expat's account balances would increase only to the extent of earnings on her investments once she moves overseas.

Another issue to be aware of is that overseas Americans must live with exchange rate risk on US retirement account balances. One of you provides this dispiriting advice: "*We have lost a lot of potential for retirement savings because of this – the only savings we have is in an 401K which means it is $ based so as we will most likely stay in France, the amount will fluctuate and be dependent on exchange rates, etc.*"

Which institutions don't want us?

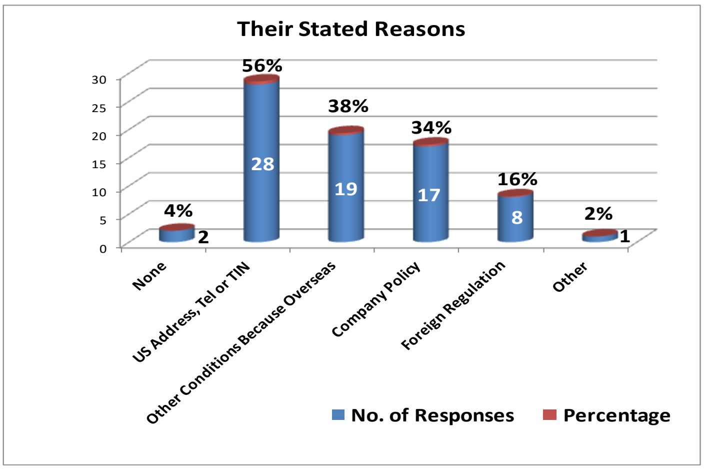
Our respondents named 10 US institutions that liquidated or threatened to liquidate their account, or placed restrictions on their account. Each institution which received at least 2 citations is listed on the chart below, on which we note how many times



each was cited. Fidelity is the "worst offender" with 8 citations: Fidelity "*made me leave*" and "*Fidelity Investments – account frozen.*" Three institutions comprise the "Other" category, with one citation each: Prudential, Wells Fargo and Ameritrade. Wells Fargo is in the process of exiting its international accounts business, so there will soon be more account terminations there. Our American expat is nervous, as her 401(k) is with Fidelity and her IRA is with Wells Fargo.

Why do they do it?

"Why do they liquidate our accounts?" she asks. As you can see by the chart below, the reason most cited is lack of US address, telephone number or taxpayer identification number (56%). One of you said "*needed US residence 183 days a year.*" The institutions also tell you that they refuse you because you are overseas (38%) and/or because of company policy (34%).



This is the same story as we discussed in Article 4 (covering US retail bank and investment accounts). Some US institutions reject overseas Americans' US retirement accounts in order to reduce their legal and financial exposure from (1) banking laws in the country of residence and (2) money laundering rules. We summarize these points below. Please click on this link if you would like to read the full discussion: Article No. 4.

European regulations

For those who live in Europe, two European regulations are the issue: The Alternative Investment Fund Managers Directive (AIFMD) and the Markets in Financial Instruments Directives (MIFID 1 and MIFID 2). These EU regulations impose onerous requirements on non-European financial professionals who market their products to European residents, so they prefer to reject accounts of American clients living in Europe.

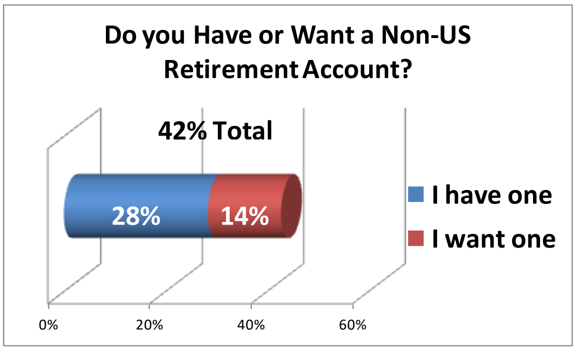
"Know Your Customer" laws

The proliferation of anti-money laundering regulations (also known as "know your customer" (KYC) rules) affects overseas Americans' accounts, including retirement accounts, wherever they live in the world. KYC rules often discriminate against non-resident accounts, considering them high risk, which triggers enhanced due diligence, so many US financial institutions have found it not worthwhile from a cost benefit analysis standpoint to service non-US resident clients. These rules trap overseas Americans trying to maintain US retirement accounts.

Non-US Retirement Accounts

Our American expat now understands that she will no longer be able to contribute to her US retirement accounts while working overseas and that she will be subject to exchange rate risk if she retires overseas. And she is really worried that her US IRA portfolio will be liquidated once she is overseas. So she would like to explore whether she could open a non-US retirement defined contribution account and, if yes, should she do so (i.e., how would the IRS treat it).

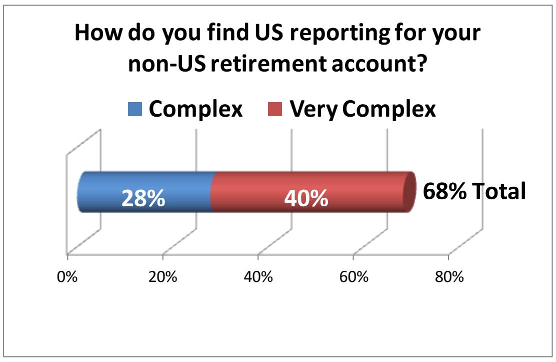
Many of us have them; many want them, but …



As you can see by the chart at right, 28% of our respondents have a non-US retirement account. An additional 14% who don't have one would like to have one, for a total of 42%. But there is great incentive not to have one, as one of you says: "*Although there is a tax treaty, we are not able to benefit from many of the tax deductible vehicles available to French residents/citizens... because we would end up paying taxes in the US on those - for example French retirement accounts.*"

Overseas Americans face many more challenges to retirement planning than their counterparts living in the US because non-US retirement plans are often subject to very heavy reporting requirements and punitive taxation.

Reporting is complex

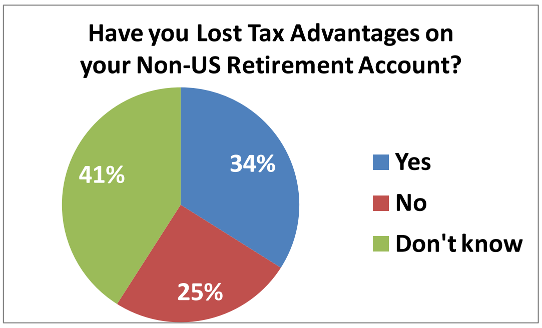


It is not always clear to overseas Americans or even their tax preparers how non-US retirement plans should be reported to the IRS; the process for determining this can be complex, time-consuming, and therefore costly. So it is understandable that, for those who do have non-US retirement accounts, 68% find the US reporting either complex or very complex.

This is because, not only must one report such accounts on FBAR and on Form 8938 under the Foreign Account Tax Compliance Act (FATCA) if the amounts in the accounts exceed the relevant thresholds, but reporting is greatly magnified if the investment is deemed a passive foreign investment company (PFIC) or if the account is deemed a foreign trust. In this article we will focus on PFICs.

Participation is taxable by the US

"*We have paid tens of thousands of dollars to the U.S. in taxes on our non-U.S. retirement account.*"



More than one third (34%) of respondents are aware that they have lost expected tax advantages on their non-US retirement accounts. But it is concerning that a large minority, 41%, do not even know. See the chart at right. As we discuss below, it is likely that some in this 41% may learn to their dismay that they have, in fact, not only lost tax advantages, but may also face punitive treatment by the IRS.

As most of us know, participation in a defined contribution retirement plan in the US (such as a 401(k), traditional IRA, Roth IRA, etc.) provides many tax advantages. Using a 401(k) as an example, neither employee pre-tax contributions nor employer matching contributions are taxed as income at time of contribution, nor are investment earnings in the account taxed. Taxation occurs at withdrawal during retirement, when one is expected to be in a lower marginal tax bracket.

Many other countries and non-US companies offer retirement plans and vehicles with similar tax benefits to their residents or employees. But, as we discuss below, many of these non-US retirement vehicles are not recognized under US tax law.

Transfers and rollovers trigger taxation

In the US, transfers of retirement savings from one qualified plan to another, such as a direct rollover from a retirement plan to an IRA, are exempt from US tax. But overseas Americans in non-US retirement plans face US tax consequences transferring these plans when they switch jobs.

Overseas accounts could be deemed PFICs

What are PFICs?

If a non-US company meets either of the below criteria, it is a passive foreign investment company:

- 75% or more of its income is passive income (including interest, dividends, rents, capital gains, royalties, or annuities)
- At least 50% of its assets are held to produce passive income

Simply put, PFICs are non-US registered pooled investments including mutual funds, hedge funds, money market accounts and insurance products. The investments in a bank account might also be PFICs if it is a money-market fund rather than simply a deposit account.

PFICs are foreign registered funds, not US funds that invest in foreign investments, so our American expat's IRA at Wells Fargo (a US fund), even though it is invested in European stocks, is not a PFIC but, if she opens an account at UBS (holding a fund registered outside the US) with identical investments, that fund would be a PFIC. Similarly, an investment in an Ireland registered fund that invests in US stocks would also be a PFIC.

Why are PFICs an issue?

The US imposed additional reporting requirements and burdensome taxation on PFICs as part of the Tax Reform Act of 1986. FATCA was passed in 2010, and its enforcement by foreign financial institutions has brought increased transparency and information sharing on non-US accounts held by Americans. Because of FATCA, the likelihood that the IRS will discover unreported PFICs has increased dramatically and overseas Americans who do not report their overseas investments will be exposed to a high risk of tax, interest and penalties.

Onerous reporting and taxation of PFICs

"*I cannot invest in mutual funds in France because too hard to report.*" FATCA requires Form 8621 to be filed every year for each PFIC. This Form requires complex record keeping and accounting, and is very time consuming to complete. Even the IRS knows this; it estimates that each Form 8621 takes 22 hours per year!

Tax rates for PFICs are punitive compared to similar investments in the US. PFIC income will generally be taxed at the highest rate possible, plus an interest charge. One of you knows this from experience: "*Certain investments (SICAVs) in my Plan Epargne Entreprise and Plan Epargne Retraite were considered PFICs and heavily taxed by the IRS.*"

For example, income distributions and capital gains are taxed at the highest marginal rate (neither the lower capital gains tax rate, nor your own lower marginal rate, applies). An interest charge is applied to deferred gains for the entire time that they are in the PFIC. For some investments, this can add up to 50+% of taxation.

If our American expat hires a US-based financial advisor who is well versed in international investment accounts, she can structure the investment to reduce this tax rate somewhat. But this will cost her dearly. Filing Form 8621 for three or four PFICs could trigger a tax preparation bill of thousands of dollars. One of you may soon learn this the hard way: "*I plan to hire a financial professional to help me with this.*"

Three non-US retirement investment vehicles

Our American expat would like to know about retirement investment vehicles in Australia, the UK and France because her non-US employer has given her the choice to work in either of these countries.

Australia: Superannuation Scheme (Super)

Australian employers are required to contribute to the Super on behalf of their employees. Employees have the option of making additional voluntary contributions, from either pre- or after-tax income. The employer's contributions, as well as the employee's pre-tax voluntary contributions, are taxed at a rate lower than the rate that would otherwise be applicable and, after age 60, withdrawals are tax-free.

But, the Super is not recognized under US tax rules. As a result:

- There are heavy reporting requirements
- Employer contributions and employee pre-tax contributions are taxable in the US
- Although the fund pays tax in Australia on the income earned in the Super, this tax is not recognized in the US, so the US taxes it again
- If the overseas American makes after-tax voluntary contributions, the Super can qualify as a trust, triggering heavier reporting and tax requirements
- If the overseas American moves the account to a new fund, this transfer could be treated as constructive receipt and therefore taxable by the US
- Withdrawals from the scheme will likely be taxable by the US

UK: Individual Savings Account (ISA)

The UK allows its residents to invest their after-tax income in ISAs, up to a certain amount each year (an amount roughly similar to employees' US 401(k) contributions). Earnings from ISAs, as well as withdrawals, are tax-free in the UK.

The ISA is not recognized by the US; therefore, the income generated by the account (interest, dividends and capital gains, even if no cash is distributed) is taxable by the US. In addition, the mutual funds held in the ISA account will often qualify as PFICs, triggering the associated reporting and taxation mentioned above.

France: Assurance Vie (AV)

In France, although not a retirement plan *per se*, the AV is the most popular vehicle for tax-advantaged investment. It is also useful for inheritance and succession purposes. Payments into the AV are made from after-tax income; income generated in the account is tax-free in France. Withdrawals are taxed by France at lower rates, but some withdrawals (and up to a certain amount) are tax-free.

The US treats the AV as a PFIC, triggering the complex reporting requirements and taxation mentioned above. One of you knows this well: "*Income from French "Assurance Vie" savings and investment accounts is taxable in US before and in addition to French taxes.*"

The dilemma overseas Americans face

Our American expat now understands that, because of her proposed move overseas, the amounts in her US 401(k) and IRA, although they would not be adversely taxed, would likely be much smaller at retirement than if she had stayed stateside, and that she would face exchange rate risk on them. She accepts this as the tradeoff to having her dream job overseas. But she is really worried that her IRA would one day be liquidated due to the KYC requirements.

On the non-US side, she is horrified that her retirement planning would be handicapped by the extraterritorial application of US laws to non-US retirement accounts. Contributing to a non-US plan, if she could even do so, would be essential for her to mitigate her stalled US retirement plan contributions. But she now knows that this would create onerous reporting, high tax preparation costs and penalizing taxation.

Our expat will have fewer resources in retirement because of her move overseas. She doesn't understand why Americans abroad, citizen ambassadors of the US, are treated so differently from Americans resident in the US. Why? And, why can't she have the same tax benefits given to others in her new home overseas?

AARO's advocacy

These issues require advocacy on many fronts.

For US retirement accounts, AARO calls for changes in US law and regulation to require US financial institutions to provide services to overseas US citizens while satisfying their KYC requirements in order to correct the injustice caused by them rejecting Americans on the sole basis of their overseas address.

US legislation and practices in tax and banking make it increasingly difficult for Americans who work overseas to save for retirement in non-US retirement accounts. American citizens abroad are unfairly burdened by a complex citizenship-based taxation system (CBT), unique in the world, with high tax preparation costs and the risk of double taxation, while receiving little of the benefits provided to citizens residing in the US. AARO's mission is to urge Congress and the Administration to pass new tax legislation and to simplify financial reporting requirements that would help overseas Americans saving for retirement.

Finally, AARO advocates ending CBT and aligning the US with the universal practice of residency-based taxation. From this would follow the replacement of the FATCA reporting regime with the Common Reporting Standard, now widely used internationally.

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The Association of Americans Resident Overseas (AARO) researches issues that significantly affect the lives of overseas Americans and keeps its members informed on these issues. Founded in 1973 and headquartered in Paris, AARO is an international, non-partisan association with members in 46 countries. For more information please email us at contact@aaro.org.