Financial Planning Considerations for U.S. Ex-Patriates in China

Introduction

There are numerous organizations that provide opportunities for Americans to spend one or more years in China teaching the English language or engaged in other educational activities. These American expats living in China are faced with numerous complications related to financial planning and taxation by virtue of the fact that they do not currently reside in the United States. We will highlight some of those complications and, to the extent possible, suggest some remedies.

Tax Issues

Several complications are related to tax issues. These include taxation of earned and unearned income, social security taxes, and tax credits related to education.

All U.S. expats are required to file a federal tax return. Most, however, will not owe taxes in the U.S. Use of the Foreign Earned Income Exclusion (FEIE), the Foreign Housing Exclusion (FHE), and the Foreign Tax Credit (FTC) allows most expats to avoid U.S. taxation.

The FEIE allows exclusion of the first $101,300 (2016) of foreign-earned income. The FTC can be chosen on any amount of foreign income which has not been excluded under the FEIE or the FHE. The FTC can be taken as either a credit or a deduction. It is generally advantageous to take foreign taxes paid as a credit against the U.S. tax liability. (FTC, 2015)

We will contrast use of the FEIE and the FTC later in this paper.

Passive Foreign Investment Company

Due to tax issues, expats need to refrain from investing in mutual funds in their country of residence. A foreign mutual fund is considered a Passive Foreign Investment Company (PFIC) by the IRS and is a tax nightmare for U.S. tax filers. Tax rates on these investments can be as high as 60-70%. Not only will the tax rate applied to these investments be much higher than the tax rate applied to a similar or identical U.S. registered investment, but the cost of required accounting/record-keeping for reporting PFIC investments on IRS Form 8621 can easily run into the thousands of dollars per investment each year. (Kuenzi, 2015)

Avoiding the PFIC trap is not difficult. Investment companies in the U.S. offer mutual funds and exchange-traded funds (ETFs) that allow investors, including expats, to invest in any part of the world and in any sector desired. For example, a search of TD Ameritrade’s web site returned 72 mutual funds in the “China Region” category. (TD Ameritrade, Mutual Funds)

Another search of TD Ameritrade’s web site returned 35 ETFs in the “China Region” category. (TD Ameritrade, ETFs)

These mutual funds and ETFs provide ample opportunity to invest in China while avoiding the PFIC trap.

Social Security

Social Security taxes are another consideration. The U.S. has Social Security Totalization Agreements with many countries. These agreements allow expats to benefit from the participating country’s social insurance system. The expat will pay the host country’s Social

Security tax but will not be required to pay the U.S. Social Security tax, thus reducing double taxation. Unfortunately, no such agreement exists between the U.S. and China. Therefore expats are technically required to pay FICA taxes in both the U.S. and China. Practically, collection of the tax in China has not been fully implemented, so not all employees are currently paying the tax.

U.S. FICA taxes must be paid. These taxes fund the Social Security and Medicare systems. The expat also needs to be aware of the self-employment tax that is due on any self-employment income. When income is earned by an employee, the employer pays half of the FICA tax and the employee pays the other half. The self-employed individual is required to pay the entire tax. The self-employed tax rate is therefore 15.3% for FICA taxes. Some have suggested that expats cut back on consulting work overseas because the taxpayer will have to pay both the employer and employee portion of Social Security and Medicare taxes. (McCallum & Olson, 2004)

Education Tax Credits

The standard admonition to begin saving early for children's education certainly applies to expats. There is no substitution for the compounding that can be obtained by investing over multiple years. For example, if you save $200 per month for 18 years in an account earning 6%, the account will grow to $77,471. If you wait until the child is 5 years old and then follow the same investment strategy, the account will only grow to $47,089 by age 18.

One of the main saving tools for college education is the 529 plan. Enacted by Congress in 1996, section 529 of the Internal Revenue Code provides tax-exempt status to qualified tuition programs created, sponsored, and maintained by individual states. Growth within such plans is tax-deferred and distributions from the plans are excludable from gross income if used to pay for qualified education expenses. Expats are eligible to enroll in the 529 plan and should be encouraged to consider doing so as part of their college planning.

Tax credits are available on qualified education expenses at qualified institutions. Chief among these are the American Opportunity Tax Credit and the Lifetime Learning Credit. Unless income limitations are exceeded, these credits are available for expenses at most American institutions of higher learning.

If expats are considering allowing their children to attend a college or university outside their country of origin, they first need to do some investigative work. A call should be made to FAFSA (Free Application for Student Aid) at 1-800-433-3243 to determine whether the institution under consideration is eligible for Federal Student Aid. Even if the family does not intend to take government loans and plans to pay out of pocket, it is important to find out whether the institution is eligible for Federal Student Aid. Being designated as "eligible" qualifies the foreign institution and its students to participate in student aid programs, such as the American Opportunity and Lifetime Learning Tax Credit programs. These credits may come in quite handy when it comes to filing the student or parents' U.S. tax return. (Zemelman, 2012)

Saving and Investing

There are numerous issues related to saving and investing of which expats need to be aware.

U.S. taxpayers may have savings in foreign financial accounts. However, if the total value of those accounts exceeds $10,000, special reporting requirements apply. These reporting requirements were created by the Bank Secrecy Act of 1970, which also created the Foreign Bank Account Report (FBAR). The Act required U.S. citizens to report their foreign financial accounts valued at $10,000 or more with the Department of Treasury (DOT) by filing the FBAR, otherwise referred to as FinCEN 114. The form must be filed online at the Financial Crimes Enforcement Network (FinCEN).

The FBAR was created to limit tax evasion. The FBAR was around for years without much enforcement, but in recent years the United States government has been increasing its efforts to investigate tax evasion and prosecute those who have failed to comply with the FBAR reporting requirements. You are required to file an FBAR if you are a "United States person" and the total aggregate balance of your foreign financial accounts meets or exceeds $10,000 – even if it was just one day out of the year.

The deadline for filing the FBAR is June 30 of each year. Federal taxes must be paid by April 15 of each year. There are no extensions available. There is no longer a paper form for filing an FBAR. All FBARs need to be filed online through the FinCEN website.

Through FATCA (Foreign Accounts Tax Compliance Act), the United States government is tracking down U.S. persons who are hiding money overseas. It is now harder than ever to avoid the DOT and the IRS. In previous years, it was relatively easy to ignore the requirement to file an FBAR or a US expat tax return. Until recently, it has been difficult for the IRS to track down noncompliant taxpayers, but with recent developments in FATCA this is no longer the case. FATCA now requires Foreign Financial Institutions (FFIs) to report all account information for foreign financial accounts held by U.S. persons. This requirement is currently active in dozens of developed countries.

Penalties for failure to file the FBAR can be severe. Non-willful noncompliance can lead to a financial penalty of up to $10,000. The maximum financial penalty for willful noncompliance with the FBAR reporting requirement is either $100,000 or 50% of the taxpayer's foreign assets, whichever is greater. Willful noncompliance can also lead to criminal charges being filed. Maximum penalties include up to five years in prison and up to $250,000 in fines. (Zemelman, Taxes For Expats, 2015)

Due to complications and potential penalties associated with savings outside the U.S., it is generally advisable to maintain a total balance in FFIs that is below the $10,000 limit. The expat should maintain a balance in their host country sufficient to meet cash flow needs. Doing this, instead of making payments from a U.S. based account, will avoid risks associated with varying exchange rates.

Investing

We've seen that it is not advisable to have savings in FFIs in excess of $10,000. Therefore, how should we advise expats to save and invest? In particular, how are they to invest for retirement? Prior to about 2010, investing was fairly straightforward. Expats could simply open a brokerage account at a U.S. brokerage firm, such as TD Ameritrade. There were no impediments to prevent expats from owning mutual funds in those accounts. The Foreign Account Tax Compliance Act (FATCA) of 2010 imposes significant new compliance burdens on non-U.S. financial institutions with U.S. clients. As a result, many non-U.S. financial institutions now simply refuse to service U.S. persons, Unfortunately, U.S. financial institutions are following suit due to FATCA and other considerations. (Behrens, 2014)

Bans on purchasing U.S. mutual funds by non-residents, including American citizens, are now the norm. These new restrictions affect bank accounts, brokerage accounts, and retirement accounts such as IRAs and 401ks. However, there are ways for expats to invest in the U.S. other than mutual funds. Although mutual funds may not be available to Americans abroad, Exchange Traded Funds (ETFs) are generally not restricted for sale to non-U.S. residents. A well designed ETF portfolio provides diversification equal or superior to traditional mutual funds. Therefore, lack of access to mutual funds should no longer be seen as a major impediment to successful expat investing.

Finally, it should also be noted that in many cases the best solution for Americans abroad is simply to keep their address of record in the U.S. Any American living abroad, even for an extended period, is well within their rights to use a U.S. address for the sake of opening accounts and receiving mail. In this case, there will be no restrictions on the account.

Investing for retirement

Americans living abroad can utilize tax-advantaged retirement accounts. However, careful tax planning and reporting is required in order to utilize IRAs or Roth IRAs. As was noted earlier in the paper, most Americans living abroad can utilize the Foreign Earned Income Exclusion (FEIE), the Foreign Housing Exclusion (FHE), and the Foreign Tax Credit (FTC) to avoid U.S. taxation altogether.

The FEIE allows exclusion of the first $101,300 (2016) of foreign-earned income. The FTC can be chosen on any amount of foreign income which has not been excluded under the FEIE or the FHE. To be beneficial, the FEIE should only be used by Americans living in countries with either no income tax or an income tax rate that is lower than the American rate. China's individual income tax rates range from 3% to 45%. The majority of Americans who are in China to teach would be in the 25-30% tax bracket.

In order to qualify for a contribution to a Roth IRA, there must be taxable income. If all income were excluded through use of the FEIE, no IRA contribution would be allowed.

It is possible to use the FEIE and the FTC in the same year. For example, consider an expat with foreign earned income of $80,000 who desires to contribute $5,500 to a Roth IRA. This expat can deduct $74,500 using the FEIE and report $5,500 of taxable income. This $5,500 can then be deposited in a Roth IRA. The good news is that, after applying standard deductions and personal exemptions (about $10,000 for a single taxpayer), no U.S. taxes will be owed.

Since the Chinese tax rate is higher than the corresponding U.S. rate, we could use just the FTC instead of combining it with use of the FEIE. This would result in reporting of taxable income, allowing a contribution to a Roth IRA. The higher Chinese tax rate also results in a tax credit that can be carried forward.

Table 1 shows the calculation of the foreign tax credit that can be carried forward for two individuals in China, one earning $56,000 and the other earning $80,000. The key points are that neither individual owes U.S. taxes, both are allowed to contribute to a Roth IRA, and both accrue foreign tax credits that can be carried forward to offset taxable income in future years.

Table 1

	Example 1	**Example 2**
Foreign Earned Income (not investments)	$ 56,000.00	$ 80,000.00

Foreign Tax (30%)	$ 16,800.00	$ 24,000.00
ROTH - IRA Contribution (no deduction)	$ 1,000.00	$ 5,500.00
Total US Taxable Income	$ 56,000.00	$ 80,000.00
Standard Deduction (single)	$ 6,200.00	$ 6,200.00
Exemptions (single)	$ 3,950.00	$ 3,950.00
Taxable Income	$ 45,850.00	$ 69,850.00
Income Tax Due (using 2015 tax tables)	$ 7,250.00	$ 13,250.00
Foreign Tax Credit	$ 16,800.00	$ 24,000.00
Carry Forward of FTC	$ 9,550.00	$ 10,750.00
Total Tax due on 1040	**$0.00**	**$0.00**

Investing for retirement presents the expat with the same difficulties as other types of investing. They may need to invest in ETFs rather than mutual funds, or they may simply need to maintain an address in the U.S.

Conclusion

Living abroad leads to complications related to taxation, saving and investing, and application of federal education credits. Developing a thorough understanding of all the nuances of these complications is likely beyond the ability and/or interest of the average expat. These individuals should, therefore, be encouraged to engage the services of a tax professional that specializes in international taxation. We have presented here a summary of the issues involved, which should inform expats of the issues to be considered and provide them with a basic understanding of the issues they will face based on their status as non-U.S. resident Americans.

References

Behrens, F. (2014, November). *Why US Accounts of Americans Abroad are Being Closes.* Retrieved May 3, 2016, from http://thunfinancial.com/us-brokerage-accounts-american-expats-closed-2015/

FTC. (2015). Retrieved May 25, 2016, from IRS: https://www.irs.gov/Individuals/International-Taxpayers/Foreign-Tax-Credit

Kuenzi, D. (2015). *Biggest Investment Mistakes Made by Americans Abroad.* Retrieved June 15, 2016, from http://www.taxesforexpats.com/articles/financial-planning/Biggest-Investment-Mistakes-Made-by-Americans-Abroad.html

McCallum, B., & Olson, D. (2004, November). Advising Potential Expatriate Clients: A Case Study. *Journal of Financial Planning, 17*(11), 72-79.

TD Ameritrade, ETFs. (n.d.). Retrieved May 25, 2016, from https://invest.ameritrade.com/grid/p/site#r=jPage/https://research.ameritrade.com/grid/wwws/etfs/categories/categories.asp?c_name=invest_VENDOR

TD Ameritrade, Mutual Funds. (n.d.). Retrieved May 27, 2016, from https://invest.ameritrade.com/grid/p/site#r=jPage/https://research.ameritrade.com/grid/wwws/mutualfunds/categories/categories.asp?c_name=invest_VENDOR

Zemelman, I. (2012). *Taxes for Expats.* Retrieved June 30, 2015, from Federal Student Aid and Tax Benefits for US Expats: http://www.taxesforexpats.com/articles/financial-planning/federal-aid-for-expats.html

Zemelman, I. (2015, February 15). *Taxes For Expats.* Retrieved May 31, 2016, from A Detailed Look at the Foreign Bank Account Report (FBAR): https://m.taxesforexpats.com/articles/financial-account-reporting/Detailed-Look-at-FBAR.html