

Improving Expats' Access to Savings and Retirement Plans

by Doris L. Speer and Paul Atkinson

Reprinted from *Tax Notes International*, October 3, 2022, p. 67

Improving Expats' Access to Savings and Retirement Plans

by Doris L. Speer and Paul Atkinson



Doris L. Speer

Paul Atkinson

Doris L. Speer is president and Paul Atkinson is a board member and chair of the Banking Committee of the Association for Americans Resident Overseas.

In this article, Speer and Atkinson examine the problems that Americans working and living abroad face in saving for retirement, and they argue that modifications to proposed legislation can alleviate them.

This article reflects the personal opinion of the authors and not necessarily that of the association.

Copyright 2022 Doris L. Speer and Paul Atkinson.
All rights reserved.

Exclusion from the financial system has become a serious problem facing Americans residing overseas, notably the increasing difficulty to access and retain savings vehicles and retirement plans. That is caused by U.S. legislation and practices in tax and banking, which make it more and more difficult for overseas Americans to save for retirement. Americans who live and work abroad and aspire to participate in a foreign workplace retirement plan there face multiple challenges under U.S. tax legislation. At the same

time, Americans who reside abroad suffer exclusion from U.S.-based savings and retirement plans largely because of U.S. legislation and practices in banking. In a survey of overseas Americans conducted by the Association of Americans Resident Overseas (AARO), discussed below, respondents confirmed how difficult these issues were.¹

But legislation now moving through Congress to expand coverage of retirement plans and increase retirement savings, summarized recently by Marie Sapirie, provides an excellent opportunity to improve the situation.² There is strong bipartisan support for this legislation, and modification to extend effective coverage to Americans overseas would be fully consistent with its spirit and intention. We would anticipate no problems with reconciliation of the three proposed bills.

Foreign Workplace Retirement Plans

The issues with foreign workplace retirement plans were addressed in detail in a 2018 Government Accountability Office report issued to Sen. Ron Wyden, D-Ore., who was then the ranking member of the Senate Finance

¹ AARO is an international, nonpartisan association with members in 46 countries that researches issues that significantly affect the lives of overseas Americans. See AARO website. AARO conducted a survey of its members and other expatriates in November 2020 asking questions on various topics relevant to expatriates, such as the Foreign Account Tax Compliance Act, banking, investment and retirement accounts, taxation, Social Security, Medicare, voting, U.S. citizen services, passport renunciation and representation in Congress; AARO, AARO 2020 Advocacy Survey, Feb. 24, 2021.

² Marie Sapirie, "Reading the Tea Leaves on Retirement Savings Tax Legislation," *Tax Notes Federal*, July 11, 2022, p. 156.

Committee.³ The GAO identified three main issues in its report, all of which relate to the U.S. tax code: taxation of contributions and earnings, taxation resulting from account transfers, and difficulty in reporting.

First, U.S. tax treatment of foreign retirement plans, as well as of foreign savings vehicles outside retirement plans, is often highly punitive. “We have lost a lot of potential for retirement savings,” said one of AARO’s members.⁴ U.S. tax treatment of contributions (employers’ as well as employees’) and earnings accruing in a foreign workplace retirement account depends on the retirement plan, but foreign plans generally aren’t recognized as “tax-qualified” under U.S. tax law. Indeed, the report states that the “IRS does not recognize *any* retirement account outside the United States as having tax-qualified status”⁵ (emphasis added). Thus, contributions to foreign workplace retirement plans generally aren’t deductible from income on U.S. tax returns. This is the case even if the foreign retirement account is considered as tax-deferred in the country where the individual works and even if the account is similar to a U.S. section 401(k) plan.

Many foreign retirement plans qualify as employees’ trusts. The tax treatment of these plans is governed by section 402(b), which states that overseas Americans must report any vested contributions to the trust on their U.S. tax return. Contributions that become vested after the year of contribution are taxable in the year of vesting.⁶ That is in contrast with the taxation of contributions in U.S.-based qualified retirement plans, such as a section 401(k) account, in which neither employee pretax contributions nor employer matching contributions are taxed as income at the time of contribution. In both cases

investment earnings in the account are taxed at withdrawal.

If the plan is *not* an employees’ trust, all tax benefits of the plan disappear. The contributions and realized earnings must all be reported on the individual’s U.S. tax return.⁷

Second, overseas Americans in foreign retirement plans also face problems transferring retirement savings, either when they switch jobs or when the employer initiates a transfer. In the United States, transfers of retirement savings from one qualified plan to another are exempt from U.S. tax. However, since foreign plans generally aren’t tax-qualified, U.S. tax law doesn’t provide participants with tax deferral if they transfer their retirement savings from one foreign retirement plan to another.

In particular, the IRS generally considers routine administrative transfers of retirement assets that occur between or within foreign retirement plans to be distributions to the participant and therefore taxable income. So — unlike participants in U.S. qualified plans — overseas Americans may owe U.S. taxes for simple transfers within or between foreign workplace retirement plans. Thus, they cannot consolidate their foreign retirement accounts without tax consequences. Indeed, they may even owe U.S. tax on the entire amount of their retirement savings when their account is transferred. The GAO recommended that Congress consider legislation modifying the tax code to rectify this problem, but we are unaware of any follow-up.⁸

Finally, reporting is a major problem. “I cannot invest in mutual funds in France because too hard to report.”⁹ The preparation of a U.S. tax return is more complex when one has a foreign retirement plan than when one does not. That is because there are different ways to report foreign retirement plans, depending on the plan. Additional forms and schedules for foreign

³ GAO, “Workplace Retirement Accounts, Better Guidance and Information Could Help Plan Participants at Home and Abroad Manage Their Retirement Savings,” GAO-18-19 (Jan. 2018). GAO prepared the report in response to a request to review steps federal agencies might take to assist participants with challenges relating to workplace retirement accounts abroad. In its written comments, the IRS stated that it generally agreed with the report and its findings. GAO-18-19, at 55.

⁴ AARO survey, *supra* note 1.

⁵ GAO-18-19, *supra* note 3, at 38.

⁶ Whether and when contributions and generated income from a section 402(b) trust are taxable as income depends on various factors, including whether the contributions are “substantially vested” and whether the participant is a highly compensated employee. *See* sections 402(b) and 83(a).

⁷ GAO-18-19, *supra* note 3, at 13.

⁸ The GAO proposed allowing routine account transfers within the same foreign workplace retirement plan or between two foreign workplace retirement plans in the same country to be free from U.S. tax in countries covered by an existing income tax treaty that provides for favorable U.S. tax treatment of foreign workplace retirement plan contributions. GAO-18-19, *supra* note 3, at 53.

⁹ AARO survey, *supra* note 1.

retirement plans are required and monthly balances must be converted to U.S. dollars to determine if the account exceeds the reporting threshold. If so, the value of their foreign retirement account must be reported even if the overseas American is no longer contributing to the account. In contrast, U.S. tax-qualified retirement plans such as section 401(k) accounts don't require any such reporting because contributions by the employee into the account are automatically deducted from gross wages on one's Form W-2, and the value of U.S. workplace retirement accounts isn't normally reported.

There is a lack of clear guidance — and considerable disagreement among professional tax return preparers — on how to comply with these rules. Thus, it is not always evident to expats or their tax return preparers how foreign retirement plans should be reported to the IRS. The tax treatment of these plans (even those in the same country) is not uniform, nor are provisions in tax treaties. The IRS doesn't provide details about how taxpayers may determine if their foreign retirement plan is eligible for tax-deferred status; how to account for contributions, earnings, or distributions on their U.S. tax return; or whether and when contributions and earnings should be taxed as income.¹⁰ Overseas Americans must use expensive tax return preparers for reporting their foreign retirement savings; because the preparers must navigate a web of complex U.S. tax requirements, the process is usually time-consuming and costly. According to the report, for an individual holding a foreign retirement account, the cost for having a tax return professionally prepared ranges from \$1,800 to \$16,000.¹¹

All this is borne out by respondents to AARO's survey: 67 percent reported to have lost tax advantages or suffered penalizing taxation on foreign investments and retirement accounts and 76 percent found complex reporting of non-U.S. investments and retirement plans.

¹⁰ In its report, the GAO recommended that the IRS commissioner clarify how overseas Americans are to report their foreign retirement accounts. The clarification could include addressing how these accounts should be designated and how the taxpayer should report contributions, earnings, and distributions. GAO-18-19, *supra* note 3, at 54.

¹¹ *Id.* at 41.

Other Foreign Savings Vehicles

For most retail savers a prudent approach to balancing risk and return is to rely on collective investments, such as mutual funds, hedge funds, money market accounts, and insurance products. These can be managed professionally and efficiently and pool risk across a diversified range of assets. Thus, such investments are commonly both (1) included in workplace retirement plans; and (2) used by retail investors to supplement any retirement savings they may have in formal plans. When such pooled investments aren't registered in the United States, they are classified as passive foreign investment companies.¹²

Additional reporting requirements and taxation on PFICs were imposed as part of the Tax Reform Act of 1986. Now, under the Foreign Account Tax Compliance Act,¹³ Form 8621 must be filed every year for each PFIC. This form requires complex record keeping and accounting, and is time consuming to complete (the IRS estimates 49 hours).¹⁴ Also, tax rates for PFICs are punitive compared with similar investments in the United States; PFIC income distributions and capital gains are taxed at the highest marginal rate¹⁵ and an interest charge is applied to deferred gains for the entire time that they are in the PFIC, which for some investments can add up to taxation of more than 50 percent.

U.S.-Based Retirement Plans

Given the U.S. tax biases and reporting challenges working to exclude overseas Americans from retirement plans where they live and work, access to U.S.-based savings vehicles is essential for many people. But there are serious impediments to such access. These generally arise from poorly designed regulation of the financial

¹² A PFIC is generally defined as a foreign corporation for which (a) 75 percent or more of its gross income for the tax year is passive income or (b) at least 50 percent of the average percentage of assets held by the corporation during the tax year produce passive income, or are held for the production of, passive income. 26 U.S.C. section 1297(a).

¹³ Section 6038D.

¹⁴ Treasury, "2022 Instructions for Form 8621," at 15.

¹⁵ Participants in a "foreign pension fund" are exempt from reporting requirements if there is an applicable income tax treaty that provides that the income earned by the foreign pension fund may be taxed as the income of the participant only when and to the extent the income is paid to the participant. Reg. section 1.1298-1(c)(4).

system rather than tax. Common problems fall into two broad classes:

1. *Many expats need access to U.S.-based savings vehicles to accumulate retirement assets.*

Almost half of the respondents (45 percent) to the AARO survey who tried to open a U.S. investment account were refused, with one saying, “We were poison.” Younger expats and other Americans by birth but who haven’t lived in the United States have few options for retirement planning — anywhere. The punitive U.S. tax treatment of saving accumulation outside the United States described above effectively forces people to search for U.S.-based options.

However, anti-money-laundering regulations, or know-your-customer rules, often discriminate against non-resident accounts, considering them “higher risk,” which triggers enhanced due diligence. Thus, many U.S. financial institutions have found that it isn’t worthwhile from a cost-benefit standpoint to serve clients residing outside the United States. Those rules trap overseas Americans who are trying to accumulate long-term savings in the United States, regardless of whether that is as part of a formal retirement account. Further, younger expats don’t usually have many assets, so they are of little interest to the few fee-based U.S. asset managers, who would accept better-off expats as clients. As one AARO survey respondent said, “All companies that I contacted refused to open an account from me.”

2. *Overseas Americans who do have established savings and retirement plans in the United States before expatriation find these plans difficult to retain.* AARO’s survey showed that 41 percent of those with a brokerage account found it either liquidated or restricted, with one saying that the bank “threw me out in 2018 and nobody would take up my investment account

elsewhere.”¹⁶ The considerations that make banks and brokerages reluctant to accept younger expat clients accumulating retirement savings also operate to discourage serving older expat clients focused on managing and drawing on such balances once accumulated. Middle-aged and elderly Americans moving abroad have frequently faced account closure, asset liquidation, and restrictions on activity. The higher balances typical of mature taxpayers’ established retirement savings are attractive to financial institutions, but fees relating to U.S. retirement plans (including IRAs) are excessive. Another survey respondent “had to liquidate retirement accounts inherited from my mother because of my foreign address.”¹⁷

A Proposed Solution

Overseas Americans need access to retirement plans somewhere. Preferably, that access should exist where they live and work. Regardless of whether that is made available, they should always have access to standard long-term savings vehicles in the United States with the freedom to accumulate, manage and draw on asset balances. Because changes in residence are normal elements of a person’s life cycle, they shouldn’t threaten an investor’s life savings. U.S. citizens shouldn’t be penalized on their U.S. retirement funds simply for not being resident there.

The following proposed legislation moving through Congress provides an excellent opportunity to improve the situation:

- The SECURE Act 2.0 (Securing a Strong Retirement Act of 2022),¹⁸ which is designed to expand coverage of employer-sponsored plans, increase retirement savings, and simplify and clarify rules. The bill passed

¹⁶ AARO survey, *supra* note 1. Respondents named the following U.S. institutions that liquidated, threatened to liquidate, or placed restrictions on their account: Fidelity Investments, Merrill Lynch/Bank of America, Vanguard, Morgan Stanley/Smith Barney, Charles Schwab, T. Rowe Price, TIAA-CREF, Prudential Financial, Wells Fargo Bank, and TD Ameritrade.

¹⁷ AARO survey, *supra* note 1.

¹⁸ Securing a Strong Retirement Act of 2022 (H.R. 2954), 117th Cong., 2nd Sess. (2022).

the House on March 29, with bipartisan support.

- The Rise and Shine Act,¹⁹ unanimously approved by the Senate Committee of Health, Education, Labor and Pensions as its version of the SECURE Act 2.0, which is a bill intended to amend the Employee Retirement Income Security Act of 1974 and the IRC to improve retirement plan provisions. It was placed on the legislative calendar on June 21.
- The Enhancing American Retirement Now (EARN) Act,²⁰ prepared by the Senate Committee on Finance, also contemplates changes to retirement plans. The Finance Committee held a hearing on June 22, to push the EARN Act forward.

The Senate's EARN Act and the Rise and Shine Act can be modified and reconciled with the House's SECURE Act 2.0 to offer an attractive vehicle for addressing the problems overseas Americans have with their foreign and U.S.-based retirement plans.²¹ Several options exist, but any, if it is to be useful, will have to modify either (1) the IRC to end the punitive treatment of savings

vehicles and retirement plans outside the United States, that is, essentially Form 8621 (PFICs) or Form 3520 (foreign trusts); or (2) the bank regulatory regime that discriminates against non-U.S.-resident banking relationships. Obvious possibilities include:

- Extending the foreign earned income exclusion regime to exclude foreign retirement plans and long-term savings vehicles from U.S. taxation.²² This would leave foreign retirement plans to be governed and taxed by host country law.
- Implementing measures that, absent probable cause relating to illicit activity, protect against liquidation or abusive restrictions when overseas Americans already have U.S.-based savings and retirement vehicles.
- Implementing measures that assure overseas Americans access to at least basic savings vehicles in the United States, such as U.S. mutual funds.

We urge Congress to build on the 2018 GAO report to include concrete action in its work strengthening retirement plans that extends meaningful coverage to Americans living outside the United States. ■

¹⁹Rise and Shine Act (S. 4353), 117th Cong., 2nd Sess. (2022).

²⁰Open Executive Session to Consider the Enhancing American Retirement Now (EARN) Act, 117th Cong., 2nd Sess. (2022).

²¹AARO sent letters to the Senate Finance Committee on June 30 and to the Health, Education, Labor and Pensions Committee on July 19, advocating for the committees to use this opportunity to correct the injustice to overseas Americans saving for retirement.

²²This type of approach was proposed in the Tax Simplification for Americans Abroad Act sponsored by Rep. Donald Beyer, D-Va., H.R. 6057, 117th Cong., 1st Sess. (2021).