IRAs, Roth IRAs and the Conversion Decision for Americans Living Abroad

David Kuenzi, CFP®, Thun Financial Advisors
Updated, December 2011; Originally Published December, 2009

Introduction

Even under the most conventional of circumstances, American taxpayers struggle to fully understand the myriad of tax advantaged retirement investment options they have. IRAs, 401(k)s, Roths, Individual 401(k)s, 403(b)s, 527s, and defined benefit employer pension plans are some of the many possible investment choices from which American taxpayers might choose. Each has slightly different tax implications and a separate set of complex compliance rules, contribution limits, mandatory withdrawal requirements and other features. Being an American abroad, however, further complicates matters by injecting additional tax and planning complexities into the equation. The good news is that Americans abroad generally have the same opportunities as do Americans at home to accrue tax benefits from tax advantaged retirement accounts. In fact, under certain circumstances and with proper planning, expats may gain more than most from the proper employment of these accounts.

To help Americans abroad sort out the financial complexities of retirement, Thun Financial is publishing a series of notes addressing key issues in retirement planning. In this first note of the series, we address: 1) the basic differences between traditional IRAs and Roth IRAs, 2) the 2010 tax law changes that expand eligibility for Roth treatment, 3) implications and special considerations for expats.

Please bear in mind the following points: For the sake of simplification, traditional IRA accounts are assumed to consist of pre-tax contributions only. State and local tax issues are not addressed.

Understanding the Difference between a "Traditional" IRA and a "Roth" IRA

Many investors will be familiar with the concept of the IRA (Individual Retirement Account), commonly referred to as a "traditional IRA." These accounts allow taxpayers to contribute up to $5000 of their earned income to an IRA account each year ($6,000 if over age 50) and receive a corresponding tax deduction (similar tax-deferred employer sponsored retirement plans such as 401(k)s have higher contribution limits). Therefore, a taxpayer in the 25% marginal tax bracket will get the immediate benefit of saving $1,250 on their current year tax bill ($5000 x .25) if he makes a maximum contribution to a traditional IRA. Investments in an IRA account grow tax-deferred until retirement. At age 59 ½ distributions can begin. Distributions are, in most cases 100% taxable at the owner's marginal tax rate, however. Furthermore, starting at age 70 ½, minimum annual distributions based on the account owners life expectancy become mandatory.

In addition to annual contributions, traditional IRA accounts may also be funded by the rollover of an employer plan (401(k), profit sharing plan, 403(b), etc.) into a traditional IRA. Where the investor has assets in such a plan but is no longer participating, rolling the assets into a traditional IRA is a tax free process.

Restrictions apply that may prevent contributions from being made. Contributions amounts cannot exceed the actual amount of earned income. Individuals covered by a company retirement plan may be partially or completely prevented from contributing pre-tax dollars to an IRA (see Appendix B).

Special considerations for expats: American citizens not resident in the U.S. may contribute to an IRA. However, they must have earned income that is not excluded by the Foreign Earned Income Exclusion (FEIE) and the Foreign Housing Exclusion (FHE). For example, an American citizen employed abroad by a foreign corporation earning $85,000 a year who is able to exclude all of her U.S. income from taxation under the FEIE will have no "non-excluded" income from which to make an IRA contribution, and therefore cannot contribute. A higher income expat with $200,000 of earned income who applies a combination of the FEIE and FHE with the Foreign Tax Credit to reduce their U.S. tax liability will be able to make a contribution. Of course, if the combination of FEIE, the FHE and the Foreign Tax Credit has eliminated all U.S. tax liability, a traditional IRA contribution will provide no immediate tax benefit, but would be taxed when withdrawn in retirement and therefore is not advised. (Instead, a Roth IRA contribution should probably be made in these circumstances, if permitted – see below.)

The "Roth IRA" Variant

The Roth IRA works in a reverse manner to the traditional IRA. Contributions to a Roth IRA generate no immediate tax savings. However, when distributions of both principal and earnings are taken in retirement, they are completely free of tax. Contribution limits for Roth IRAs are the same as for regular IRAs. There is also an option to convert an existing traditional IRA (as well as other tax-deferred retirement plans) to a Roth IRA. All or part of the traditional IRA can be converted. Conversion, however, requires the account holder to report the full value of the amount converted as regular income in the year converted (see further discussion below).

An important advantage of the Roth IRA is that it has no minimum distribution requirement. The entire balance of the account can simply be left to grow free of tax and then bequeathed to heirs. Those heirs, in turn, can stretch withdrawals out over their entire lifetime. That realistically implies that Roth contributions made now by younger individuals could remain in the account, growing tax free for 100 years or more before being fully withdrawn. The compounding effect of such long-term tax free appreciation implies a very, very large boost to inter-generational wealth accumulation. Of course, leaving the Roth IRA untapped through retirement implies that the account owner has other financial resources on which to draw.

2010 Rule Changes

The benefits of Roth, for reasons to be discussed, accrue mostly to wealthier tax payers who will find themselves in high marginal tax brackets during their retirement years.

However, most well-to-do tax payers have until now not been able to benefit because individuals with modified adjusted gross income of above $105,000 (or for those married filing jointly, $176,000) have not been able to contribute to a Roth IRA. Furthermore, all taxpayers with modified adjusted gross income above $100,000 have been prohibited from converting traditional IRAs to Roth IRAs. Starting in 2010, these income limits end. Millions of upper income Americans previously shut out of Roth will become eligible (see Appendix A).

Special considerations for expats: Many American expats who have married non-Americans elect to file married, filing separately. Until now, taxpayers using this filing status have been prohibited from converting traditional IRAs to Roth IRAs. Beginning in 2010, that restriction ends.

To Convert or Not Convert?

As previously noted, conversion of a traditional IRA to a Roth IRA requires the account holder to report all of the amount converted as regular income in the year of the conversion. That may result in a very large tax bill due at the time of conversion for individuals who have accumulated large IRA accounts.

Generally, it is better to pay taxes later rather than sooner. However, under the right circumstances, the Roth conversion (and/or annual contributions) allows for the payment of taxes now at potentially lower rates than if the funds were withdrawn in retirement. The Roth also allows all future appreciation to be totally tax free. The value of these benefits may more than offset the negative impact of having to pay the tax currently. The calculation of whether or not it makes financial sense to contribute to a Roth IRA or convert a traditional IRA to a Roth IRA largely depends on two variables: 1) The marginal tax rate at which taxes will have to be paid on amounts converted or contributed now, 2) the marginal tax rate prevailing at the time money is withdrawn from the traditional IRA, if conversion is not carried out. Analysis shows that when retirement tax rates are expected to be the same or higher than current rates, the Roth contributions and Roth conversion is unambiguously the right choice. Only when marginal tax rates in retirement are expected to be substantially lower than current marginal tax rates does the traditional IRA prove optimal.

Judging Current and Future Tax Rates

Determining current and future tax rates is a complex exercise. First, we obviously cannot have complete certainty about tax rates far in the future. Second, good financial planning can help reduce tax rates now and in the future which in turn will alter the pay-off of employing Roth. The major strategic issues affecting tax rates include:

1) *Proper calculation of the current marginal tax rate.* Marginal tax rate refers to the rate at which your last dollar of taxable income is taxed. This can range from 10% for individuals with less than $8,375 of taxable income in 2010 to 35% for individuals with more than $373,650 (these rates are set to rise in 2011 – see appendix C). Taxpayers considering a Roth conversion must be aware that conversion may raise the marginal tax rate at which at least some of the converted amount is taxed. For example, an individual with taxable

income of $110,000 in 2010 falls into the 28% marginal tax bracket. If he has a $100,000 traditional IRA to convert and converts all of it in 2010, the effect of the additional income will be to push him into the 33% marginal tax bracket, causing part of the converted amount to be taxed at the 33% rate and part at the 28% rate. In such cases, it may be optimal to spread the conversion out over several years so that the conversion itself does not push the taxpayer into a higher tax bracket. Careful analysis of an investor's tax situation is required.

2) *A changing year-to-year financial and tax situation*. Individuals who experience large swings in their annual income may be most able to benefit from Roth. For example, consider a taxpayer with $100,000 in a traditional IRA account, who experienced a temporary period of unemployment during 2009 and as a result has little or no income for the year. The taxpayer finds new, high-paying work in 2010 and in general is likely to be well-off in retirement. This is an ideal situation for Roth conversion. Most of the $100,000 in the traditional IRA can be converted at a relatively low tax rate in 2009. This can result in large tax savings. In such a scenario, it may be optimal to contribute and/or convert even if the investor ends up in a relatively low marginal rate during retirement.

3) *Estimating retirement year tax rates*. To come up with as realistic as possible an estimate of marginal tax rates 20 or 30 years down the road requires a lot of careful financial planning and some educated guesswork. First, taxpayers need to make as accurate an estimate as possible of all likely sources of taxable income in retirement: required minimum distributions from non-Roth retirement accounts; social security, dividends, interest income, capital gains, etc. Consideration of the national economic and financial environment must also be factored in: most analysts expect tax rates to rise over the medium to long term in the United States. (Rates could also be lower, but it is hard to find anyone who expects that.) Tax rates are already scheduled to increase in 2011 (see Appendix C).

Special considerations for expats: Expats have to go through the same process of estimating current versus future marginal tax rates, but their calculation includes a few extra factors:

1) State taxes are an important part of the Roth conversion calculation for Americans abroad. In many cases (but not all) Americans living abroad are not subject to state taxation. If they intend to return home and retire in a state that taxes traditional IRA distributions (as most states do), then the ability to convert without paying state taxes on the conversion (and thereby permanently removing the assets from both state and federal taxes) effectively lowers the bar in favor of conversion.

2) Host country taxation must also be considered. If the Roth IRA conversion

amount is subject to a local taxation at a higher rate that the applicable U.S. rate, it may be better to defer conversion until returning to the U.S. if return is anticipated.

3) Americans who anticipate living abroad forever want to consider a host of unique planning opportunities to reduce their retirement marginal tax rate. The availability of such strategies may militate against Roth conversion. For example, consider the case of an American citizen living in Hong Kong, married to a Hong Kong citizen who is not an American citizen or a U.S. permanent resident. Suppose the American citizen has large amounts of unrealized capital gains in an investment portfolio and anticipates selling those holdings to fund retirement. In that case, the American citizen should consider annual gifts of stock to his Hong Kong spouse (in 2009 an American citizen can gift up to $130,000 per year to a non-U.S. citizen spouse without paying gift tax). The spouse, in turn, can sell the stock and pay no capital gains since Hong Kong does not have a capital gains tax. Properly employed, such a strategy may reduce the American citizen's retirement tax rate to a level well below his tax rate at the time the conversion decision had to be made.

The myriad of circumstances and possibilities raised by living abroad are too many, and too specific to each individual case to list completely here. Suffice to say, the Roth conversion decision requires careful consideration and the required analysis is further complicated by additional financial planning factors unique to Americans abroad.

Tax Diversification

For many younger taxpayers or the merely moderately well-off, making a close to definitive conclusion about whether conversion is financially optimal may not be possible. There can be too many uncertainties about retirement year financial circumstances for an accurate calculation to be made. This is one of the reasons that taxpayers may want to pursue a strategy of "tax diversification." In this scenario, the taxpayer contributes some annual amounts to a Roth and some to a traditional IRA. Likewise, part of an existing traditional IRA is converted and part is not. This approach effectively hedges the taxpayer against the risk of being in a much higher or lower marginal tax environment during retirement than they anticipated when they made the decision between traditional and Roth.

Special considerations for expats: Tax diversification makes especially good sense for Americans abroad because the complexity of the conversion calculation is augmented by their special tax and planning circumstances. The more complicated the calculation, the higher the risk that the wrong decision will be made and therefore the greater the benefit of a "hedged" approach as offered by the tax diversification strategy.

Conclusion

Although specific analysis of each situation is required, most wealthy Americans will find the Roth contributions and strategically executed Roth conversions make sense. For taxpayers not expecting to be in the higher tax brackets during retirement, the decision is not clear-cut.

For many moderately financially well-off Americans, Roth may ultimately generate a very large tax savings, but changing personal financial circumstances or changing future tax rates could cause this not to be the case. With tax rates already scheduled to ratchet up beginning in 2011, and the nation's fiscal and political outlook leading many observers to forecast much higher taxation levels in the future, the calculation appears to support Roth contribution/conversion for more and more taxpayers. But the decision is always dependent on a host of individual factors. Status as an American expatriate will have great impact on the calculation. As always, it is best to consult with a qualified investment advisor or tax consultant before making a final decision.

Contact: david.kuenzi@thunfinancial.com

About Thun Financial Advisors

Thun Financial Advisors is a US-based, fee-only Registered Investment Advisor that provides investment management and financial planning services to individuals residing in the U.S. and overseas. We maximize long-term wealth accumulation for our clients by combining an index allocation investment model with strategic tax, retirement and estate planning. We guard our clients' wealth as though it was our own by emphasizing prudent investing with a focus on wealth preservation and growth.

Thun Financial Advisors, LLC
313 Price Place, Madison, WI 53705 | 608-237-1318; Skype: thunfinancial |www.thunfinancial.com

Appendix A: Scheduled Changes to IRA Rules

	Current Rules	Rules as of January 2010
Contributing to a Roth IRA	Individuals with modified adjusted gross income (MAGI) below $120,000 or married couples with MAGI below $176,000 are eligible to contribute, assuming that they have earned income at least equal to their contribution.	No change to the current rules but traditional IRA contributions can be immediately converted.
Converting to a Roth IRA	An individual can convert a traditional IRA or employer plan to a Roth IRA if his or her MAGI is $100,000 or less. Married couples who file separately cannot convert (unless they have lived apart for more than one year).	The income limit disappears. Any taxable income created by the conversion can be either: - Divided evenly between the 2011 and 2012 tax years. - Or recognized in 2010. Married couples who file separately are allowed to convert

Appendix B: Attributes of Traditional IRAs and Roth IRAs

	Traditional IRA	**Roth IRA**
Tax advantage	Tax-deferred earnings.	Tax-free earnings.
Eligibility[1]	• Investors must have earned income equal to or greater than their contribution. • Investors must be under age 70½. • There is no limit on income, but contributions may not be tax-deductible	• Investors must have earned income equal to or greater than their contribution. • Investors modified adjusted gross income must fall within the limits prescribed by the IRS.
Maximum contribution allowed by law	• $5,000 for tax year 2009 ($6,000 if age 50 or older).	• $5,000 for tax year 2009 ($6,000 if age 50 or older). • The maximum Roth contribution depends on the investor's income.
Tax deductibility	• If the investor (and spouse, if married) were not covered for any part of the year by an employer plan, they can deduct their total contributions up to the lesser of $5,000 ($6,000 if age 50 or older) or 100% of compensation.	• Contributions are nondeductible.
Taxes on withdrawals	• Ordinary income tax on earnings and deductible contributions. • No federal tax on nondeductible contributions. • State tax may apply.	• Distributions from contributions are federally tax-free. • Distributions from earnings are federally tax free if over age 59½ and have owned the Roth IRA for at least five years. If under 59½, distributions are tax-free if the investor owned the Roth IRA for at least five years and the distribution is due to death or disability or for a first-time home purchase (with a $10,000 lifetime maximum for the latter). • State tax may apply.
Penalty for early withdrawal[2]	• 10% federal penalty tax on withdrawals before age 59½ unless an exception applies.	• Distributions from contributions are penalty-free. • 10% federal penalty tax on withdrawals of earnings before age 59½ unless an exception applies.
Required minimum distributions	• After age 70½. • Exception: A new federal law allows investors to skip their RMD for 2009.	• None.

[1] If married and filing a joint income tax return, the nonworking spouse may also contribute to an IRA. The total contribution for both spouses cannot exceed the income of the working spouse for the contribution year.

[2] Distributions received before reaching age 59½ may not be subject to the 10% federal penalty tax if the distribution is for a first-time home purchase (lifetime maximum of $10,000), post-secondary education expenses, substantially equal periodic payments taken under IRS guidelines, certain medical expenses exceeding 7.5% of adjusted gross income, an IRS levy on the IRA, health insurance premiums (after receiving at least 12 consecutive weeks of unemployment compensation), or disability or death.

Marginal income tax rates	2002	2003–2007	2008–2010*	2011*
Thresholds based on 2009 taxable income**				
Single: Over $372,950 Married filing jointly: Over $372,950	38.6%	35%	35%	39.6%
Single: $171,551–$372,950 Married filing jointly: $208,851–$372,950	35%	33%	33%	36%
Single: $82,251–$171,550 Married filing jointly: $137,051– $208,850	30%	28%	28%	31%
Single: $33,951–$82,250 Married filing jointly: $67,901–$137,050	27%	25%	25%	28%
Single: $8,351–$33,950 Married filing jointly: $16,701–$67,900	15%	15%	15%	15%
Single: $0–$8,350 Married filing jointly: $0–$16,700	10%	10%	10%	No 10% bracket
Capital Gains Tax Rates				
Long-term capital gains (10% and 15% tax brackets)	10%	5%	0%	10%
Long-term capital gains (All other tax brackets)	20%	15%	15%	20%
Short-term capital gains	Taxed as ordinary income	Taxed as ordinary income	Taxed as ordinary income	Taxed as ordinary income
Dividend Tax Rates				
10% and 15% tax brackets	Taxed as ordinary income	5%	0%	Taxed as ordinary income
All other tax brackets	Taxed as ordinary income	15%	15%	Taxed as ordinary income

* For 2010 and 2011, the table reflects what is outlined in the current tax code.
** These tax tables adjust annually for inflation.

Copyright © 2011 Thun Financial Advisors

DISCLAIMER FOR THUN FINANCIAL ADVISORS, L.L.C., THE INVESTMENT ADVISOR

Thun Financial Advisors L.L.C. (the "Advisor") is an investment advisor licensed with the State of Wisconsin, Department of Financial Institutions, Division of Securities. Such licensure does not imply that the State of Wisconsin has sponsored, recommended or approved of the Advisor. Information contained in this brochure is for informational purposes only, does not constitute investment advice, and is not an advertisement or an offer of investment advisory services or a solicitation to become a client of the Advisor. The information is obtained from sources believed to be reliable, however, accuracy and completeness are not guaranteed by the Advisor.

The representations herein reflect model performance and are therefore not a record of any actual investment result. Past performance does not guarantee future performance will be similar. Future results may be affected by changing market circumstances, economic and business conditions, fees, taxes, and other factors. Investors should not make any investment decision based solely on this presentation. Actual investor results may vary. Similar investments may result in a loss of investment capital.

Thun Financial Advisors does not provide tax, legal or accounting services. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions