

# thun

financial advisors

## A Primer on Investing and Financial Planning for Americans Living Abroad

- The high cost of investing through foreign investment firms
- Tax and legal implications of investing in non-US funds
- Managing currency risk
- Rules for proper portfolio management when living abroad
- How to benefit from tax advantaged retirement accounts when living abroad
- Family matters: taxation strategies for families of mixed nationality
- How to choose an advisor or manage investments on your own

thun financial advisors research  
May 2009

## Introduction

### The Problem: How to make years abroad as financially rewarding as possible

Many Americans find that years spent abroad turn out to be the most financially rewarding of their lives. However, while careers advance and bank accounts grow, expats are often too busy to devote the attention necessary to develop a winning long-term investment plan. The predicament is compounded by the complex tax, logistical and strategic planning considerations faced by Americans living outside the United States. The good news is that these issues can be successfully managed and need not impede implementation of a sound long-term wealth accumulation plan. While recognizing that each individual situation is unique and requires its own set of solutions, this report identifies key issues that confront almost all expatriate Americans when it comes to investing and managing their finances. Topics addressed include:

- Where to maintain banking and investment accounts
- Currency exposure and global investing
- Portfolio construction
- Retirement planning
- Mixed nationality families
- Finding the right investment advice

### 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](http://www.thunfinancial.com)

## Where to Bank and Invest

***Problem: Should Americans abroad keep their money in the US, country of residence or off-shore?***

Americans abroad often end up investing through financial institutions in their place of residence or in popular banking centers such as Switzerland or Hong Kong. This is especially true when living abroad becomes a permanent or semi-permanent situation. However, when a full accounting is made of all factors that need to be considered, investing through non-US financial institutions is almost always a costly mistake for Americans. Why?

- 1) *Fees.* Whether one chooses to go with a large reputable investment bank headquartered in Switzerland or venture in to the world of “off-shore” banking, a large part of an investors potential gain will be consumed by the very high fees charged by non-US financial institutions. These fees are high everywhere in the world, but they are still much lower on average in the US compared to everywhere else. A recent Harvard Business School study of mutual fund fees by country found that among 18 developed European, American and Asian markets, fees in the US were by far the lowest. For example, average expenses for mutual funds sold in Switzerland, the UK and Canada were 43%, 50% and 279% higher, respectively, than in the US. The numbers are especially striking for money market funds, where returns are very low to begin with: Swiss money market fund expenses average 1.14% while in the US the average was 45%

less.<sup>1</sup> If an investor goes further afield into the world of “off-shore” investing in places such as Lichtenstein, Cyprus and the Cayman Islands, fees, commissions and transactions costs will be substantially higher than even high cost Europe.

- 2) *Taxes.* Taxes are the next big reason that Americans should stay away from non-US registered investments. Long-term investors in US securities benefit from a low capital gains tax rate (15%). Additionally, taxes are paid on a deferred basis (only when the investment is sold). Neither of these huge tax advantages applies to investments in mutual funds, hedge funds or other kinds of pooled investments not incorporated in the US. Rather, such non-US securities are classified by the IRS as Passive Foreign Investment Companies (PFIC) and are subject to a special, highly punitive tax regime. PFIC rules can easily push tax rates on investment income to as high as 60-70%. Furthermore, the US government is currently in the process of ratcheting up enforcement of the PFIC rules. (See the more detailed discussion of PFIC rules below).
- 3) *Reporting:* The complexity of the US tax code makes year-end accounting statements provided by US brokerages invaluable. US brokerage firms like Schwab and Fidelity supply their clients with detailed banking activity reports in the required IRS format and segregate

---

<sup>1</sup> Khorana, A., Servaes, H., and Tufano, P., “Mutual Fund Fees Around the World,” Harvard Business School Working Paper No. 901023, 2006.

dividends, qualified dividends, taxable and non-taxable interest income, short and long term capital gains, to name only the most important categories, each of which requires distinct tax treatment. Non-US institutions generally do not provide this kind of detailed reporting.

- 4) *Compliance*: Assets of more than \$10,000 held by American citizens at financial institutions outside the US must be reported to the US Treasury Department. Filing the required documentation may increase the likelihood of an IRS audit. Penalties for not filing are severe and, as with PFIC rules, the US government is moving to significantly expand enforcement of the reporting requirements.
- 5) *Safety*: Regulatory standards in global banking centers range from very high (Switzerland) to almost non-existent in some of the more exotic off-shore banking locales. FDIC deposit and SIPC

investment insurance automatically cover all US accounts, but are unavailable for non-US accounts.

***Recommendation: Keep investment accounts in the US and bank accounts in country of residence***

For the reasons discussed above, we advise American citizens to maintain investment accounts in the US. In addition, Americans abroad should open local bank accounts in their country of residence. Local income and living expenses should be managed through this local account to avoid the expense of constantly converting between currencies. Money allotted for savings and investment, however, should be moved to the US account and invested.

For a fuller treatment of this topic, see the article [\*Six Reasons Why Americans Living Abroad Need to Keep Their Investments On-shore and In the US\*](#) (available at [www.thunfinancial.com](http://www.thunfinancial.com) or by request from Thun Financial Advisors.)

**Passive Foreign Investment Company Taxation: What Americans Abroad Need to Know**

Passive Foreign Company Investment (PFIC) Rules are one of the least well understood aspects of the US tax code that directly impact Americans Abroad. The rules are designed to discourage Americans from moving money outside of the United States where it is more difficult for the IRS to monitor investment activity. Any non-US incorporated investment fund that derives 75% of its income from passive activities is by definition a PFIC. This includes virtually all hedge funds and mutual funds incorporated outside the US. The details of the PFIC rules are complex but boil down to a default taxation formula in which all capital gains are taxed at the highest current tax rate (currently 35%). There is no long-term capital gains rate of 15% as would apply to a US mutual fund. To make matters worse, the IRS assumes that all gains were made ratably over the entire holding period, and then assesses interest on the amount of gain that was deferred during the holding period. This formula can easily result in total taxation rates above 50%. Owners of PFICs can elect an alternative taxation method called "mark-to-market." This method requires taxes to be paid annually at ordinary income tax rates on the increase in the value of the fund over the course of the year. There is no low capital gains rate and no tax deferral until sale. Finally, losses cannot be used as offsets to other capital gains!

The point is that PFIC taxation is so punitive that virtually no non-US investment fund is likely to be attractive enough to offset these negative tax consequences. Nevertheless, many tax preparers are either unfamiliar with the rules or simply unaware of the registration of their clients' investments. In past decades, this rarely created a problem because the IRS has been lax in its enforcement of the PFIC rules. But this is changing. Legislation pending before Congress seeks to dramatically strengthen the enforcement of foreign banking rules. The legislation increases PFIC enforcement measures, among many other actions designed to stop US citizens from using foreign accounts to avoid taxes.

## Currency Management and Global Investing

***Problem: How can Americans abroad best manage the impact of big currency swings and diversify investments globally?***

While Americans have to be aware of the pitfalls of taking their money out of US institutions, this does not mean that they should not be invested globally. On the contrary, Americans abroad who expect to remain outside the US for an extended or indefinite period of time need to manage their long-term currency risk by matching the currency denomination of their investments with the currency in which they expect to incur the bulk of their future expenses (such as a home mortgage, college funds and retirement funds). For example, an American who is a long-term resident of Europe and who expects to raise and educate children and possibly retire there should have a large share of their investments in European equities and bonds. Matching the currency of likely future expenses to assets in this manner limits the risk that large currency swings will upend long-term planning goals. For Americans abroad who expect to

return to the US after only a few years, currency management issues are usually far less important.

***Recommendation: Invest in a diversified, multi-currency portfolio of global assets***

We recommend that Americans abroad pay particular attention to the importance of maintaining global diversification and avoid a common bias towards US investments. Many expatriate Americans are not sure where their careers and lifestyles will take them. For these investors, a very broadly diversified multi-currency portfolio makes the most sense. For Americans planning long-term residence in Europe, a portfolio with a large component of European stocks and bonds makes the most sense. *Buying foreign stocks and bonds does not require working with a foreign broker. A diversified portfolio of European stocks, for example, can usually be bought more cheaply through a discount US broker than through a European broker.*

## Portfolio Management

***Problem: What special considerations apply to building an investment portfolio while living abroad?***

Aside from adjusting the asset mix of an investment portfolio to reflect current and future residency plans (as discussed above), the fundamentals of successful investing fortunately apply to all investors no matter their location or nationality. To be successful in the long run, investors need to focus on four issues when making investment choices:

- 1) ***Diversification:*** Currency management strategy is a compliment to, but not a substitute for proper investment portfolio diversification. All investors, no matter where they live need to invest in a broad array of assets including US stocks, international stocks, bonds, emerging markets, real estate and commodities. Proper diversification can substantially mitigate

losses incurred during a severe market downturn. This, in turn, helps sustain portfolio stability and reduces the risk that the investor will sell out near a market bottom as a result either of need or emotion. Decades of academic research and real world investor outcomes confirm that diversification is the only way of maximizing returns for a given level of risk.

2) *Risk*: Within a broadly diversified portfolio, the relative weight of higher return/higher risk investments (stocks, commodities) versus lower risk/lower return investments (bonds) needs to match the risk profile of the investor. Generally, as we move towards retirement we need to reduce our exposure to a large market downturn by steadily increasing the weight of bonds in our portfolio. Many other factors—job security, near-term spending plans, or expected college expenses for example—also impact this calculation. Accepting the right amount of risk is critical to providing the returns necessary to meet planning goals without being overwhelmed by the impact of market volatility.

3) *Low expense*: The ability of professional stock pickers and strategists to “beat the market” has been shown time and time again to be exceedingly rare. A study of the performance of all US Large Company mutual funds over 20 years found that the average fund underperformed the S&P 500 stock

index by 2.6% per annum.<sup>2</sup> A European study looking at the period 1975-2006 found that a mere 0.6% of all fund managers succeeded in consistently picking more winners than losers.<sup>3</sup> The biggest reason for this dismal record lies in the high fees charged by fund management companies and brokerage firms. With long-run, annual stock market returns averaging around 9%, sacrificing 2.6% of an investment to annual fees and expenses will reduce the total return on an investment by 39% over 20 years. Over 40 years the investment return will be reduced by 62% (see Figure 1). This is why investors must pay close attention to the cost of investing their money.

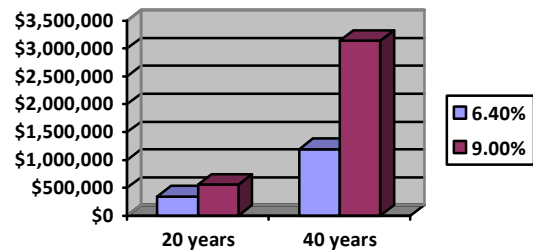


Figure 1: The difference in total return on a \$100,000 investment at 9% and at 6.4% (average equity index return and average equity mutual fund return respectively) over 20 and 40 years.

4) *Tax management*: A less obvious but still very serious impediment to long-term investment success is poor

<sup>2</sup> Arnott, R., Berkin, A., and Ye, J., “How Well Have Taxable Investors Been Served in the 1980s and 1990s?,” *Journal of Portfolio Management*, Summer 2000.

<sup>3</sup> Barras, L., Scaillet, O., and Wermers, R., “False Discoveries in Mutual Fund Performance,” *Swiss Finance Institute*, no. 08-18, 2008.

investment tax management. Portfolios with high turnover not only incur high commission and trading expenses, but they also trigger taxation of capital gains earlier and at higher rates. A stable, low turnover portfolio that defers taxation and benefits from the low long-term capital gains rate will generate dramatically better after-tax returns than a fund that performs equally well on a pre-tax basis but which has high turnover.

***Recommendation: Use modern investment tools such as exchange traded funds to build a stable, diversified portfolio with the right amount of risk; pay as little as possible in fees and taxes***

These recommendations are especially relevant to Americans abroad because of the unfortunate tendency of many expats to change investment strategies as frequently as they change countries and to pay unnecessarily high investment fees (which are often times hidden in complex derivative structures and non-transparent investment funds). These mistakes are easily avoidable. Modern investment tools such as index mutual funds and exchange traded funds give investors all the tools needed to build a globally diversified portfolio of assets. No matter where they live, American investors working on their own or with the assistance of an advisor can open an account at one of the large US discount brokerage firms and successfully employ these principles to build a winning long-term investment portfolio.

## Retirement Planning for Americans Abroad

***Problem: Benefitting from the significant tax advantages of qualified retirement accounts is difficult because of their complexity, especially when the special tax implications of living abroad are factored in***

Understanding how to properly employ tax advantaged retirement accounts is particularly vexing for Americans abroad because they often do not have the easy option of simply adopting the company 401k plan. Rather, Americans abroad must proactively learn how to employ IRAs, Roths and SEPs to fill the gap. Over a lifetime of saving and investing, these accounts can provide enormous benefits not only in terms of tax savings, but also in terms of asset protection in litigation situations and estate planning. But investors need to very carefully navigate the complex rules governing these accounts to avoid mistakes that might

trigger unnecessary taxation or even loss of tax deferred status. Furthermore, optimizing the tax advantage of these accounts also requires careful calculation of how stock and bond investments are allocated between taxable and tax-deferred or tax exempt accounts.

For the self-employed, proper use of retirement savings accounts is particularly important because of the onerous tax regime imposed by the IRS on Americans with self-employment income derived from non-US sources. Generally, Americans employed abroad by non-US employers can escape the self-employment tax altogether. But any American living abroad with self-employment (Schedule C) income must pay the full 15.3% tax (unless exempted by a bilateral “totalization agreement”). The burden is compounded by the fact that the IRS limits deductions when determining the

amount of self-employment income subject to the tax. However, this burden can be offset by the unique ability of self-employed individuals to shield large amounts of income from the federal income tax through the recent innovation of the “solo 401k.” A simplified version of the cumbersome company 401k, the “solo 401k” offers self-employed entrepreneurs a chance to defer up to \$49,000 a year of self-employment income.

***Recommendation: learn how to make full use of tax advantaged retirement accounts***

As investors, we are limited in our ability to affect the long-term performance of stock and bond markets. As taxpayers, however, we have the power to pay more or less taxes depending how well we manage the tax impact of our investment strategies. Proper tax management can add as much as 3% of total annual return to a stock portfolio.<sup>4</sup> At that rate, you can add an additional 100% of total return to your investment account in 24 years, simply by making good strategic tax choices.

Proper employment of tax deferred or tax exempt investment accounts is a critical element of long-term investment success. We recommend Americans abroad take full advantage of these opportunities. The trick is to understand how they work. For that, be prepared to do a lot of homework or seek out the advice of a qualified advisor. Finally, steer clear of non-US retirement accounts. These structures have no special tax status as far as the IRS is concerned and often will in fact incur the highly punitive wrath of the PFIC rules (see section above on choosing where to maintain accounts).

**Double Taxation and Bilateral Tax Treaties – Key Points to Understand**

- The US maintains tax treaties with many foreign countries. These treaties are designed to reduce the incidence of double taxation.
- Tax treaties generally do not reduce the US tax burden of Americans abroad, but may reduce the treaty country’s taxation of Americans living in the treaty country.
- “Totalization Agreements” are designed to coordinate the benefits of the US social security system and the host country’s national pension system. They allow US citizens to get “credit” in the US Social Security system for contributions made to a foreign pension system.
- Totalization agreements can be especially important for self-employed Americans abroad because they can reduce or eliminate the need to pay the 15.3% self-employment tax.

---

<sup>4</sup> Jeffrey, R.H. and R.D. Arnott. “Is your Alpha Big Enough to cover its Taxes?” Journal of Portfolio Management, Spring 1993.

## Family Matters

***Problem: Many Americans who live abroad end up marrying non-Americans. From the investment and financial planning point of view, this can create opportunities as well as dilemmas***

***Recommendation: Use the tax code to keep as much money as legally possible away from US taxation***

The planning strategy should be to keep as much income as possible out of the taxation jurisdiction of IRS. There are a variety of ways to do this in mixed marriages. For example, if the non-US spouse is earning significant income then “married filing separately” is the appropriate election when it comes to US taxes. This election limits deductions and credits, but prevents the IRS from taxing the non-citizen spouse’s income.

Husbands and wives also need to plan carefully around estate and gift tax issues. At death, there is no limit to the size of the estate that can be transferred tax free to a surviving US citizen spouse. However, if the spouse is not a US citizen, estate taxes will be immediately imposed at a rate of 45% on the entire taxable

estate amount. Trusts can be used to address this problem.

Spouses can also transfer up to \$133,000 a year (for 2009) to their non-citizen spouse gift tax free. This provision can provide a very useful planning device for Americans with spouses with residence in a lower tax regime country. By making an annual spousal gift, the money can be permanently removed from the tax purview of the US government, both in terms of investment income taxes and estate taxes.

The US tax code provides a plethora of tax advantaged ways to save for your children’s education. Coverdell accounts and 529s are usually the best options. Many Americans abroad may be surprised to find that many universities outside the United States are “qualified” institutions. This means that distributions from these accounts can be used to pay tuition and expenses at these non-US schools. Furthermore, because of the large amounts of money that can be sheltered from taxation through 529s, these accounts have great value as long-term estate planning tools in the right circumstances.

## Choosing an Investment Advisor or Doing it Yourself

***Problem: Brokers and advisors outside the United States do not understand how US taxation works and most brokers and advisors in the US do not understand the special issues of Americans abroad. Can I do it myself or do I need an advisor?***

Modern information technology and the internet have made “do it yourself” a serious option for those expats who are prepared to make a substantial and ongoing time commitment to learning the applicable taxation issues and the theory and practice of sound portfolio management. Accounts can be established at a discount broker in the US and securely managed over the internet from anywhere in the world.

***Recommendation: keep it simple if doing it yourself or seek out the help of a qualified advisor***

If going it alone, focus on simplicity: mimic a “lazy portfolio” like the one offered by David Swenson, the head of the Yale University Endowment in his book *Unconventional Success*. Never forget to factor in the tax consequences of investment decisions. Most importantly, avoid the big pitfalls that get most people in trouble: not being sufficient diversified or investing in funds that supposedly “only go up” a la Bernie Madoff.

For individuals who think their time is more productively spent building their own careers or nurturing their families, we recommend seeking out the advice of a “fee-only” Registered Investment Advisor with experience working with expats.

Why fee only? Fee-only advisors are compensated only by their clients. By not taking commissions or maintaining fee splitting agreements with fund companies and

brokerages, the potential for conflict of interest between the client and advisor is reduced.

Why Registered Investment Advisors (RIAs)? RIAs are legally bound to act as fiduciaries to their clients. That is, they have a legal obligation to put the clients’ interests ahead of their own. Brokers are not RIAs and do not have a fiduciary obligation to their clients.

What to avoid: Avoid relying on investment advice from advisors such as stock brokers or insurance agents, who are compensated by selling products through commissions and fee sharing agreements with the issuers. In these situations, the advisor is likely to recommend investments based on the size of their potential compensation rather than the quality of the investment. And be especially careful when considering investments registered in “off-shore” locations. There is a high incidence of fraud among these operations. Even legitimate investment schemes in these regions typically lack investor safe-guards that exist in the US. Finally, understand the tax rules regarding investments outside the United States.

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

Thun Financial Advisors L.L.C. (the “Advisor”) is an investment adviser 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.

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.