American Expat College Savings and 529 Plans

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Executive Summary

American expats with children who may attend college are faced with many of the same obstacles as stateside parents. This article discusses:

- College Savings Vehicles: 529 College Savings Plans, Coverdell Savings Accounts, and Other Tax-Efficient Investing Techniques
- Unique Challenges Faced by U.S. Expats in Investing in These Vehicles

Thun Financial Advisors, L.L.C. is a U.S.-based, fee-only, Registered Investment Advisor that provides investment management and financial planning services to Americans 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, currency, retirement and estate planning. We guard our clients' wealth as though it were our own by emphasizing prudent diversification with a focus on wealth preservation and growth.

Introduction

Funding a college education is a significant expense for many families and is on the rise. For the past 50 years, the cost of tuition in the United States has increased at an average annual rate of almost six percent, nearly twice the pace of inflation. Consequently, understanding different investment options in saving for and paying for college is essential for parents. With proper planning, saving for college can be an integral part of a long-term wealth accumulation strategy. This Thun Research article discusses 529 college savings plans, Coverdell ESAs and other tax-efficient investing techniques that Americans living abroad can utilize to successfully save for their children's education. This article also focuses

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on some of the unique obstacles faced by U.S. expats in taking advantage of these special opportunities.

529 Savings Plans

A 529 education savings plan allows investors to make contributions to a special account dedicated to future higher education expenses. 529 plans can be established by state governments or by private educational institutions. Every state has at least one 529 education savings plan. Although American expats might not be considered residents of any particular state, they can still open a 529 college savings plan because no state places residency restrictions on 529 account owners.

529s and College Outside the U.S.

Even if a child chooses to go to school outside of the United States, 529 savings can be applied to expenses in certain cases. For the 2012–2013 school year, there were 451 international (non-U.S.) schools that were eligible. Details on which international institutions qualify can be found on the Federal Student Aid website www.fafsa.ed.gov.

Contributions to these 529 savings programs are not tax deductible. Instead, the earnings on the investments accumulate tax-free until the college costs are paid from the funds. Distributions from qualified tuition programs are tax-free in the U.S. if the funds are used to pay for qualified higher education expenses. These expenses broadly include tuition, room and board, textbooks and computers.

Distributions from 529 education savings accounts can be used at any accredited university in the U.S. as well as some qualifying institutions abroad. If funds are withdrawn from the plan to use at a non-eligible institution, or for non-eligible expenses, investors must pay income tax and a 10 percent penalty on any earnings withdrawn.

If an individual expat is not subject to state taxes, then the state tax benefits which usually create an incentive to use the home state plan are not relevant. This allows American expats to choose a 529 plan solely on the basis of investment merit. Therefore, Thun Research recommends using one of the better 529 savings plans such as Ohio's or Utah's.

There are many advantages in using a 529 savings plan as an American living abroad. Importantly, donors are able to make large contributions to a 529 plan free of U.S. gift tax. There is also flexibility in how to use funds in a 529 plan. If the beneficiary decides not to attend college, the investor can change the beneficiary to another family member or distribute funds to themselves. However, the distributions of earnings not used for qualified higher education expenses will be subject to income tax plus a 10 percent penalty tax. Furthermore, American expats must also carefully consider the local country tax implications discussed below.

Coverdell Education Savings Accounts

Another method of saving for higher education costs are Coverdell Education Savings Accounts, or ESAs (formerly called "Education

IRAs"). Yearly contributions of up to $2,000 are allowed for each child under age 18. Parents, grandparents, other relatives, friends, and the child for whom the account is established can contribute to a Coverdell ESA. However, the right to make contributions begins to phase out once Adjusted Gross Income (AGI) is over $190,000 on a joint return ($95,000 for singles). American expats can establish a Coverdell ESA account even if they are not living in the United States.

Contributions to Coverdell ESAs are not tax-deductible; the benefit for investors is that income and investment gains are not taxed. Like a 529 savings plan, distributions are tax-free if spent on qualified education expenses. If the child does not attend college, the money must be withdrawn when the child turns 30, and any earnings will be subject to income tax and penalty. Unused funds can be transferred tax-free to a Coverdell ESA of another member of the child's family who has not reached age 30.

College Saving Options Through Traditional Investment Accounts

In addition to special tax-advantaged accounts, for many American expats, using traditional investment or retirement accounts for college expenses can also be an excellent choice. Money can be distributed out of an IRA (including a Roth IRA) at any time to pay college costs without incurring the 10 percent early withdrawal penalty that typically applies to withdrawals from an IRA before age 59 1/2. However, distributions are still subject to tax under the usual rules for traditional IRA distributions. In certain cases (and depending on bilateral tax treaties), retirement accounts can be used to mitigate certain tax problems created by 529 plans in the country of residence.

A taxable brokerage account is also a powerful savings vehicle for a college education when coupled with low-cost and tax-efficient Exchange Traded Funds (ETFs). By investing early, taxpayers are able to minimize capital gains and enjoy the lower long-term capital gains rate. In certain cases, this might be the best option for Americans abroad who face uncertain local country tax consequences of a college savings account designed in and for the United States. In any case, brokerage accounts are better than using a local country college savings scheme that creates uncertain tax consequences in the United States.

Specific Considerations for the American Expat: Country-of-Residence Tax Considerations

All of the above college savings options are available to American expats. However, there are no tax treaties between the United States and any foreign country recognizing the tax-advantaged status of 529 savings plans or Coverdell ESAs. Depending on local country tax laws, using a U.S. college savings plan may actually be a counterproductive way to save for college expenses because investment gains and distributions could be subject to local country tax laws.

Local country college savings accounts can also create similar headaches for expats when filing U.S. tax returns. In the United Kingdom, Child Trust Funds (CTFs) and Children's Bonus Bonds are available to help parents begin saving for college. In Canada, parents have the option to open up a Registered Savings Plan (RESP) which allows tax deferral similar to a 529 plan.

All of these accounts offer tax deferral options not recognized in the United States. This will generally make them a poor investment option for most American expat investors who are subject to U.S. taxation.

Maximizing Investment Returns Through College Savings Accounts

American expat parents are encouraged to start saving early for college expenses. In the context of a larger investment portfolio, it may make sense to place the more aggressive portion into a 529 savings plan. When these appreciated assets are taken out of a 529 plan or Coverdell ESA account to pay for college expenses, there will be no capital gains tax. Investors maximize tax deferral and the benefit of tax-free withdrawals by using these special accounts.

The type of college savings plan that you choose is ultimately only as good as the investment manager and financial plan behind it. Thun Financial integrates Coverdell and 529 plans into an investor's broader portfolio which includes retirement accounts, taxable brokerage accounts and pension plans to maximize tax advantages. This leads to a coherent and *integrated* investment strategy that maximizes long-term wealth accumulation.

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For further information

Please see the Using 529 Plans as an American Expat Webinar.

Thun Financial Advisors Research is the leading provider of financial planning research for cross-border and American expatriate investors. Based in Madison, Wisconsin, David Kuenzi and Thun Financial Advisors' Research have been featured in the *Wall Street Journal, Emerging Money, Investment News, International Advisor, Financial Planning Magazine* and *Wealth Management* among other publications.