American Expat 529 and Other Education Savings Plans

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Executive Summary

American expats with children are faced with many of the same obstacles as stateside parents in funding educational expenses. This article discusses:

- College and K-12 savings plans: 529 savings plans, Coverdell savings accounts, and other tax-efficient investing techniques
- Unique challenges faced by U.S. expats investing in these plans

Introduction

Funding a college education is a significant expense for many families. And this expense 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 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 savings plans, Coverdell ESAs and other tax-efficient investing techniques that Americans living abroad can use to successfully save for their children's education. This article also focuses on some of the unique obstacles faced by U.S. expats in taking advantage of these special opportunities.

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529 Savings Plans

A 529 education savings plan allows investors to make contributions to a special account dedicated to future education expenses. 529 plans can be established by state governments or by private educational institutions. Every state and Washington, D.C. 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 savings plan because no state places residency restrictions on 529 account owners.

Contributions to these 529 savings programs are not tax deductible and therefore are made with after-tax money. Instead, the earnings on the investments accumulate tax-free until the educational costs are paid from the funds. Contributions can be made by parents, grandparents, other relatives, and even friends.

529s and College Outside the U.S.

Even if a child chooses to go to college outside of the United States, 529 savings can be applied to expenses in certain cases. For the 2019–2020 school year, there are 417 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.

Distributions are tax-free in the U.S. if the funds are used to pay for qualified higher education expenses including trade schools, community colleges, and universities. These expenses broadly include tuition, room and board, textbooks and computers. Non-qualified expenses include travel, insurance, application and testing fees, and loan payments.

Distributions from 529 education savings accounts can be used at any accredited university in the U.S. as well as some qualifying institutions abroad — see the inset for details. Additionally, recent tax-reform now allows up to $10,000/year in 529 withdraws for US K-12 school tuition (but only tuition). Whether 529 funds can be used for K-12 tuition outside the US has not been clarified yet.

If funds are withdrawn from the plan to use at a non-eligible institution, or for non-eligible expenses, the distribution will be subject to income tax and a 10 percent penalty.

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 & fees. Therefore, Thun recommends using one of the better 529 savings plans such as Ohio's or Utah's.

There are many additional advantages in using a 529 savings plan. Donors are able to make large contributions to a 529 plan free of U.S. gift tax. There is 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 for qualified expenses.

That said, American expats must also carefully consider the local country tax implications discussed later in the article.

Coverdell Education Savings Accounts

Another method of saving for 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 the contributor's 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.

Similar to a 529, Coverdell contributions are not tax-deductible, but the gains and income are tax-free. Distributions are tax-free if spent on qualified education expenses including college. Coverdell funds can be used for K-12 tuition and expenses (like books and supplies) whereas 529 funds can only be used for K-12 tuition. Additionally, if the child does not attend college, the money must be withdrawn when the child turns 30, and any earnings are subject to income tax and penalty. Unused funds can be transferred tax-free to a Coverdell ESA of another member of the beneficiary'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.

A taxable brokerage account is 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 usually better than using a local country college savings scheme that creates uncertain tax consequences in the United States.

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 and Roth 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.

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

All of the above education 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. education savings plan may actually be a counterproductive way to save for education expenses because investment gains and distributions could be subject to local country tax laws. In those cases, the expat may consider changing the account ownership to a trusted US -based family member.

Local country college savings accounts can also create similar headaches for expats when filing U.S. tax returns. In the United Kingdom, Junior ISAs 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 advantages not recognized in the United States. This will generally make them a poor investment option for American expat investors because of harsh US tax treatment.

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 education savings plan that you choose is ultimately only as good as the investment manager and financial plan behind it. Thun Financial integrates education savings 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.

Please contact us if you would like to discuss further.

Contact Us

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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 has been featured in the *Wall Street Journal, Emerging Money, Investment News, International Advisor, Financial Planning Magazine* and *Wealth Management* among other publications.

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