White Lighthouse Investment Management

As an American Abroad does a Roth Conversion or Roth IRA still make sense?

Feb 12, 2021 3 min read

Overview: *A Roth conversion is one of the most classic and effective tax planning tools available to U.S. taxpayers. If your taxes rise a Roth IRA conversion or contributions can save you a considerable amount of money in taxes over the long term. However, there can be major drawbacks to this strategy for U.S. citizens who are currently living abroad or planning to retire abroad.*

A Roth conversion involves transferring retirement funds that were previously tax-preferred (ie you have not paid tax on these funds yet) into an account where you pay the tax now and the account grows tax-free. You may also have access to a Roth IRA or a Roth 401(k) which are funded with after-tax dollars so that all contributions and future earnings can be withdrawn tax-free!

If you are working abroad it can be hard to make qualified contributions to a Roth IRA account. Many Americans qualify for the Foreign Earned Income Exclusion which excludes up to $108,700 (2021) of your foreign income and potentially reduces your earned income to $0. Those who utilize the Foreign Tax Credit instead are still limited by contribution limits that are based on your filing status and modified adjusted gross income. For example, a Married couple, filing jointly, would need to earn less than $198,00 (2021 MAGI) to be able to fully contribute to a Roth IRA.

Most countries do not recognize Roth accounts and would simply see them as a taxable brokerage account, taxing capital gains and dividends at their local tax rates each year. Countries that have a wealth tax, like Switzerland or Italy, would also include this account in their annual calculation.

A Roth may still be attractive for residents in countries with low tax rates or countries that do not tax foreign-derived income. There are also a handful of countries that recognize the tax-free nature of the Roth, including Canada, France, and the United Kingdom (UK). These are generally recognized under US Tax Treaties.

If you have found yourself living in a country that does not recognize Roth IRAs (like Germany, Switzerland, or many other European countries) look for opportunities to take advantage of tax-loss harvesting (selling some investments at a loss) to re-balance your account in a way that will limit capital gains and dividends during your time in that country. Hold ETFs in your Roth IRA, these are generally more tax-efficient because they have little turnover (meaning less potential capital gains). Keep careful records that show your after-tax basis in the plan, these are your contributions to the account. This will help limit your tax exposure in the foreign country.

Remember your situation is unique. Financial planning for those looking to move back to the US or outside the US can take advantage of some exciting tax and retirement planning opportunities.