The Uncovered Truths about IRA Accounts for Americans in Switzerland, How you may be able to lower your US Tax bills in 2012, 2013 and beyond

Jonathan Lachowitz, CFP® | Financial Planner | Investment Advisor

LinkedIn

Jan 15, 2013

Did you know that as an American taxpayer living and earning income in Switzerland that there is a good chance that you can lower your US taxes (if you owe any) and earn tax deferred income that is not entirely excluded (mainly by the Foreign Earned Income Exclusion, Foreign Tax Credits, Housing Exclusion, Personal Exemption and Itemized Deductions) then you can make a tax deductible contribution to your IRA account as long as your employer sponsored retirement account (generally the 2nd pillar for Swiss based employees) is not tax qualified in the US (where plans such as 401k and 403b are tax qualified).

Individual Retirement Accounts for US tax payers; whether they live in the United States or abroad (e.g. Switzerland) can play an important role in helping individuals prepare for their retirement. Understanding and using IRA accounts properly can play an integral role in implementing a family's financial plan. The following article is meant to inform and clarify some common misconceptions about IRA accounts and highlight some of the ways you can benefit, even as an overseas American, by using your accounts as part of your overall investment strategy:

IRA Account Variations: Summary

The most common and some less common types of IRA accounts are:

a) **Traditional**: An account that allows individuals to direct pre-tax income, up to specified annual limits and allows investment to grow tax deferred with no income or capital gains tax consideration until the money is withdrawn.

b) **Contributory:** An IRA account that is generally used for annual contributions; though can be co-mingled with other similar (for tax purposes) tax deferred accounts.

c) **Rollover:** Has the same tax deferral characteristics as a traditional IRA but is generally used when 401k or 403b money from a US employer based retirement plan is going to be used to fund a new employer's plan (in the US). If the money is not transferred to a new employer's plan or if contributions are made or funds co-mingled, this will turn into a Traditional IRA. Accounts A-C may have the after tax contributions, called basis, that will not be taxed upon withdrawal.

d) **Roth:** A retirement account whose investments generally grow **tax-free** in the US. The accounts are generally funded with after-tax contributions and are not subject to required minimum distributions when the account owner turns age 70 ½.

e) **SEP:** A Simplified Employee Pension (Account) that is generally used by self-employed individuals or partnerships and can be used for the business owner and employees. The lesser of $50,000 (for 2012, $51,000 for 2013) or 25% of the employee's compensation can be contributed in any year. This can be used by self-employed individuals living and working in Switzerland and when used as an advanced strategy in coordination with a Swiss 2nd pillar can be an interesting way to both save for retirement and avoid the "double taxation" potential for 2nd pillar contributions by US taxpayers.

f) **Inherited:** An IRA that is left to a beneficiary after the account owner's death. A Beneficiary does not have to be a US citizen, but estate and/or income taxes may be owed at the time of receiving the IRA or at the time of distribution of funds from the IRA account.

g) **Simple:** A Savings Incentive Match Plan for Employees is similar to a 401k and 403b but easier to set-up and administer especially for small employers. Employee contribution limits are $11,500 in 2012 ($12,000 in 2013) [Add $2500 for employees 50 and over]. Simple and SEP IRAs have some similarities and differences, it is best to seek professional guidance in deciding which is best for your small business.

h) **Self-Directed:** This type of IRA generally means that the account owner is responsible for the investments in the account. In the industry, however, this is generally thought of as a fringe/grey area where individuals and/or advisors make constructs where the IRA invests in real estate, small business shares, foreign funds, unregistered securities; though the owner is prohibited from self-dealing. ***The author is not a big fan of self-directed IRAs; there are too many stories of ill advised clients being taken advantage of in this area. If you decided to pursue this avenue, you should do it with eyes wide open, due diligence is key.***

The above summary of types of IRAs is a brief description of the types of IRA accounts that exist. Each one has their own nuances and below are some other key elements to consider:

IRA Accounts – Parties

There is generally only one **owner** of an IRA account, though you may find an IRA has been placed in a trust [with multiple beneficiaries] or has a trust as one of the beneficiaries. The **Primary Beneficiary** (ies) will receive the account assets (generally designated as a percentage of the account value) upon the death of the account owner. The **Contingent beneficiary** (ies) will generally only receive account assets if there are no surviving primary beneficiaries. The **custodian** (institution that holds customers' securities for safekeeping) is generally the administrator of the IRA account and will process: account opening and closing, changes of beneficiaries, distribution of assets upon death of the account owner and reporting of tax information to the IRS.

Beneficiaries & Probate

There is generally not a limit to the number of primary or contingent beneficiaries of an IRA account. The important thing is that the % allocation of the account adds up to 100%. If you are living in the US, you can make a **per-stirpes** election so that if a beneficiary dies, and the beneficiary is not changed by the time of death of the account owner, that the branches of the beneficiary (decedent) will receive that beneficiaries share. The per stirpes rules are set by individual states and generally have a set formula for how much a spouse, children, grandchildren etc would receive.

Incorrect beneficiary elections (e.g. to an ex-spouse, or excluding one or more younger children) are one of the biggest mistakes found in IRA accounts. It is good to periodically review your elections.

Upon the death of the account owner; a death certificate and proof of identity are generally the only things needed for the custodian to pay out the death benefit. If the decedent is living outside the US, then a IRS Transfer Certificate would generally be needed too to show that Estate taxes have been paid, or that no estate taxes are due.

The passing of IRA account assets to the beneficiaries DO NOT pass through **probate**, so the will of a decedent generally will not dictate the distribution of the IRA assets unless a trust or no beneficiary (meaning that the estate is generally the beneficiary) is elected. This is a major misconception and so for someone dying in Switzerland it is highly unlikely that the forced heir-ship rules can be applied to the distribution of IRA assets.

US Tax Deferral or Tax Free Growth

Earnings within an IRA account are not subject to US income tax in the year they are earned and there is no worry about short or long term capital gains, the 30 day rule, tax rate of collectibles, gold, etc. Traditional IRAs are only taxed at the time distributions are made, and at the time, the withdrawal is generally treated as ordinary income. If you have a US tax basis (see next section) in your IRA account, then the tax basis can be used up in proportion to your IRA account value in order to lower your US taxable income. The rules here can get complicated, especially if you have multiple IRA accounts, a tax advisor's help may be a good idea.

Roth IRAs do not have any taxes on the earnings in the Roth or when distributions are made. The money that was deposited into the Roth was "after-tax" money the income however does remain income tax free. Generally speaking, distributions should only be made if the money is needed to be spent or invested in an asset that can not be held (or easily held) in an IRA account.

US Tax Basis: IRA accounts and Swiss 2nd and 3rd Pillar Accounts

One of the biggest mistakes a US taxpayer can make is in losing track of their US tax basis in a retirement account, whether the account is a US account or a Swiss 2nd or 3rd pillar. Tax basis, meaning, money that has already been taxed by the US, when it is in an IRA account can generate tax deferred income, but the basis itself can be withdrawn with no additional tax due. Unless you are distributing the entire account, the tax basis needs to come out proportionally. I recommend to all US tax payers, keep very good records of your US tax basis, especially in your Swiss retirement plans, this could end up saving you thousands or even hundreds of thousands in US taxes in retirement.

Withdrawal Limits and Restrictions: Key Ages 59 ½ and 70 ½

Withdrawal rules are somewhat different for Roth IRAs and Traditional IRAs. For a traditional IRA, withdrawals before age 59 ½ are subject to Federal and State Income taxes and a 10% penalty. If your withdrawal is for a qualifying reason (e.g. up to lifetime limit of $10k for a first time home purchase, qualified education expenses, death or disability, unreimbursed medical expenses or health insurance if you are not employed), the 10% penalty can be waived. If you are between age 59 ½ and 70 ½ you can take a withdrawal from your traditional IRA and only be subject to taxes at the Federal and State level.

You will have to start taking **Required Minimum Distributions** (RMDs) by April 1 of the year after you turn 70 ½. Thereafter your RMD will be by December 31st each year. [So if you delay until April 1st the first time you will have 2 RMDs that tax year.] Required Minimum Distributions are calculated based on the end of year account value, your age, and the tax actuarial table provided by the IRS. Most brokers will calculate this number for Traditional IRAs but not inherited IRAs. The **penalty for not taking an RMD is 50%** of the value of the amount that was not withdrawn on time, almost as bad as an FBAR penalty.

For Roth IRAs, the contributions (that are not the result of an IRA conversion) can come out of the account at any time with no tax and no penalties. If you have reached age 59 ½ (or meet another qualifying reason for distribution) and the earnings have been in the account at least 5 years, then you can withdraw the earnings tax free and penalty free. Some Roth distributions of earnings are subject to taxes if certain conditions are not met and others are subject to taxes and penalties; the details are beyond the scope of this article. Also, there are no required minimum distributions at age 70 ½ or any other age for a Roth IRA.

IRA Contributions, Tax form, Limits and Timing

IRS form 8606 is used to report non-deductible contributions to an IRA account and is used to accumulate these contributions over the years. This is a very important form to file as this is "proof" of tax basis that will be used later in life to withdraw part of your IRA account without being double taxed. This form is also used to report conversions of Traditional IRAs to Roth IRAs and distributions from Roth IRAs. It is best to ask your tax advisor which forms you need to file each year, and which ones need to be kept over a long period of time to show basis contributions.

Generally taxpayers have until April 15th of the following year to make a contribution; so **for the tax year 2012, you have until April 15th 2013** to make a contribution. For contributions made in the first 3 and a half months of the year, the custodian will generally ask which tax year it should be reported for. For plans such as the SEP IRA, contributions generally can be made up until the time the tax return is filed (after April 15th if necessary) since the maximum contribution amount is often dependent on the final financial results for the business.

For the tax year 2012, contribution limits to IRA accounts are $5000 and increased to $6000 if you are 50 or older. For 2013, these limits jump to $5500 and $6500 respectively. A non working spouse of a taxpayer can also make contributions to an IRA account if the filing status of the couple is married filing jointly. No matter how high your income is, you can contribute to an IRA account each year. The limits that you will read about are as to whether or not you can deduct the contribution from your taxable income. These limits are somewhat complicated depending on income level and filing status, it is best to look them up online. As stated in the beginning of the article, these income limitations for deductibility are generally not relevant for Traditional IRAs if you are not covered by a qualified retirement plan (most Swiss based employees are not); though you may have some AMT affects as to the full deductibility of the IRA contributions.

If your tax status is married and filing jointly and your adjusted gross income on your US tax return is less than $173,000, then you can contribute to a Roth IRA (instead of a Traditional IRA); for single or head of household this limit is $110,000. For a full breakdown of the limits see the Retirement Plans section of the IRS website. Not however that Roth IRA contributions are not deductible.

One of the most important reasons to make regular annual IRA contributions, whether you can deduct them or not, is because the earnings will be tax deferred or tax-free. With the top marginal tax rate of 39.6% and 20% on earned income and long term capital gains, along with additional 3.8% Obamacare/Medicare tax on investment income, this tax deferral can really add up over time.

Converting a 401k to an IRA Account

Employer sponsored 401k and 403b plans allow account holders to convert their accounts to an IRA account once their employment is terminated, and normally not before then. One of the biggest advantages (and responsibilities) in converting a 401k is the wide variety of investment choices. If your 401k accounts have any tax basis, there is a good chance that your conversion can be split into a Traditional and a Roth IRA. The best place to start for information is with the plan sponsor and by calling the member benefits department; they will be able to provide you with all of the paperwork necessary. Many plan sponsors will close out your 401k or 403b by sending you check. Be careful, this check must be re-deposited into an IRA account within 60 days otherwise the IRS considers this a distribution, which will then be subject to taxes. Even better, if you can have the check made out to the receiving institution, with you or your account as the ultimate beneficiary, this can also help avoid the penalty.

Converting a Traditional IRA to a Roth IRA

In 2010, in an effort to raise more money for the US Treasury, the US started to allow anyone with a Traditional IRA account to covert this into a Roth IRA, pay the income taxes due, and then get tax free growth for the rest of their lives in the Roth IRA. While this may sound like a deal that is too good to be true, it is in fact a complicated decision and most analysis that I have done, the concluding advice has been against doing the conversion. The conversion can make sense if the tax payer has a very low income in a given tax year (e.g. going back to school, between jobs, etc) or if the eventual money is meant for heirs and not for the account owner. The conversion option still exists and the conversion can be spread over several years, thought I would recommend having a thorough analysis done with a professional before going ahead with the conversion.

IRA Accounts and Children

If your children have earned income (summer job, royalties, college job, etc) contributions can be made to an IRA account in their name (Roth or Traditional). As a part of an overall gifting and wealth transfer strategy in a family, parents can gift money to children to fund their IRAs as long as the children have the earned income; it is also strongly recommended that US tax returns are filed for the children in the years that these contributions are made (and any other years where tax returns should be filed).

Investing in an IRA Account

Thanks to the broad diversity of investments available in the US markets, there is a huge variety of investment choices for how to invest your IRA funds. You will generally find that you can even invest in many Swiss based companies such as Nestle, Novartis, Roche and many others (though the accounts will mostly be dominated in dollars). Custody and trading fees tend to be significantly less in the US than most Swiss based custodians. Since your IRA accounts are unlikely to be most or all of your retirement income (unless most of your retirement savings was transferred there from a US plan), the IRA investment should complement your overall investment strategy. I prefer to invest income generating investments there (as opposed to capital gains) because of the difference in US tax rates.

US Tax Qualified Plans & Taxation in Switzerland

If you have a US IRA account, live in Switzerland and are no longer a US tax payer (eg you gave up your green card properly or you renounced your US citizenship) then by my understanding of Article 18 of the US-Swiss Income tax treaty (see technical notes of the treaty too) only Switzerland has the right to tax your IRA distributions. If this is the case and you decide to take out your entire IRA distribution, you can generally get lump sum taxation (as though you were distributing a 2nd pillar) and pay a tax rate in the neighborhood of 6% to 12%. My suggestion is that if you are planning to do this, please get an expert opinion from a US tax professional and a Swiss tax professional if you plan to make a large distribution in this manner. [I know of several people who have done this successfully but it takes careful planning and may be subject to challenges by the IRS; though the challenges I have heard about have been found to be incorrect due to the IRS agent's misunderstanding of the tax treaty.]

In order to not be liable for taxes in the US, the Swiss lump sum taxes absolutely must be paid. If you are still a US citizens or US taxpayer for other purposes, then the US will still have the right to tax your distribution.

Most tax advisors I have spoken with in Switzerland treat US IRA accounts like 3rd pillar accounts. They do not report them as part of the wealth and do not report income inside the accounts as taxable income in Switzerland. However, this is a grey area. My understanding is that the Swiss cantons and federal government have the right, but not the obligation to tax these accounts; but I would strongly encourage you to follow your own tax Swiss advisors advice.

A detailed discussion of the US-Swiss tax treaty is beyond the scope of this article but note that government pensions paid from one country may not be taxable in the other country and social security and AVS have special treatment too, as do dividends on other investment income.

Where to get advice & set-up / Custody an IRA account

There are several places you can turn to for more detailed advice. If you work with a US tax advisor, they can run a quick simulation to see if you are eligible to contribute to an IRA and if you would be able to benefit in the current year from making a deductible IRA contribution. They can also tell you what your marginal tax rate is on investment income compared to an estimate of what they would be if you are earned some of the income in your IRA account. [These simulations can also be run with on-line tax calculators and tax preparation software.]

If your financial advisor understands US tax and retirement planning issues, they should also be able to help you with more or less all of the items outlined in this article. If the advisor is specialized in working with Americans in Switzerland, they should know, or easily be able to research the use of IRA accounts in your overall investment plan.

Custodians such as Fidelity, Interactive Brokers, E*Trade, Charles Schwab, TD Ameritrade, even UBS (in the US) offer custody services for IRA accounts. Most of these firms should be able to set-up an IRA account for overseas Americans; though you will want to check with them to see if this is still possible; and for some types of plans (e.g. SEP or Simple IRAs), the custodian may not offer these services. [The author is not specifically recommending any of these firms, there are hundreds of companies in the US that offer IRA custodial services, the list above is just some of the larger firms that have decent online facilities.]

Net Unrealized Appreciation

If you have employer stock in your IRA (or similar account) and you are about to leave your employer, you may be able to get capital gains treatment, instead of ordinary income treatment from your IRA distribution. This will only apply to appreciated company stock (the more capital gains the better). If you are under age 59 ½ you would likely be subject to an IRA distribution penalty making this election less attractive. Net Unrealized Appreciation has a smaller benefit in 2013 since most people who can take advantage of this are in upper tax brackets, and so their long-term capital gains rates are now likely to be 23.8% (20% capital gains and 3.8% Obamacare/Medicare tax) instead of 15% previously. This is a very specialized area and you should seek out a CPA, Attorney or Advisor who is familiar with this concept.

Very high Earners with non-Swiss Independent Income

Even if you are in the fortunate position of having very high earnings (high six figures or into seven figures) and some of your income comes from consulting, directors fees or other “non-employment” related income (especially if it is outside of Switzerland) you have more alternatives to defer US taxes. It is possible to create custom designed defined benefits plans (similar to traditional IRAs) to defer income far in excess of the SEP IRA limits. There are a number of factors to consider that are beyond the scope of this article; seek professional guidance.

Why are IRA accounts more important in 2013?

For almost all US tax payers, tax rates will be going up in 2013; the higher amount of earned income you have, the worse off you are. This makes all forms of US tax deferral that much more important both for reducing taxable income (by making deductible IRA contributions annually) and by earning more of your investment income in a tax deferred account such as an IRA, 529 [for qualified education including many institutions outside the US including Switzerland].

Conclusion

IRA accounts, when used as a component of your overall financial planning goals can help to reduce US taxes owed and help with your estate planning. There are a number of opportunities and traps for the unwary and many nuances that even seasoned professionals don't come across on a regular basis. It pays to do your research and ask a lot of questions. I often say that traditional good advice for Swiss employees may not work out so well for American taxpayers living and working in Switzerland and this remains the case. The US tax code is terribly complex and every financial decision you or your investment advisor makes needs to be considered in the additional perspective of the US tax effects. Now more than ever it is necessary to be proactive and diligent in order to meet your financial goals and avoid making costly mistakes.

The information in this article is thought to be correct at the time of publication and is meant for general information purposes only. The use of IRA accounts and other financial and tax references may or may not apply to your situation. You are advised to contact your own tax, legal and/or financial professional who understands the context and details of your situation in order to best advise you on your own tax and investment planning. Circular 230: The information in this communication should not be used by any taxpayer for the purpose of avoiding any federal, state or local tax penalties.

Jonathan Lachowitz, CFP® is a Certified Financial Planner ™ professional and fee-only Investment Advisor in Switzerland (and the United States) at White Lighthouse Investment Management in Lausanne. He is on the board of directors of the Swiss Financial Planners Organization (SFPO) in Bern and American Citizens Abroad (ACA) in Geneva. White Lighthouse Investment Management subordinates to the Polyasset asset manager's Code of Professional Conduct.