Saving for College: Tips for Expat Americans with Non-U.S. Spouses

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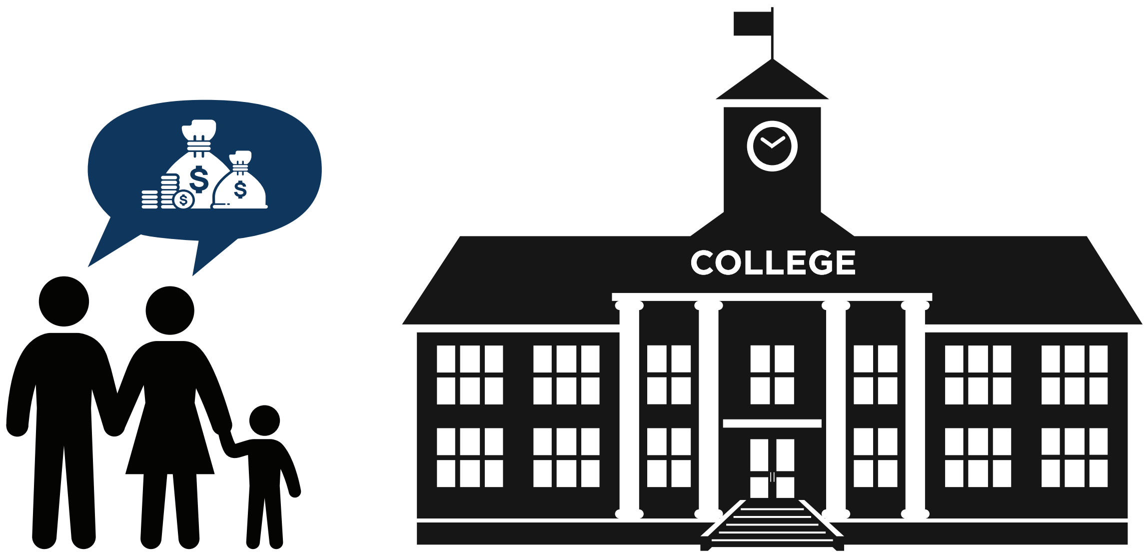
Expat Americans married to foreign spouses and who have kids who one day plan to attend college face special challenges (and opportunities) when saving for higher education. One challenge is simply the costs involved. In the U.S., university tuitions have been increasing at above-average inflation rates for years. Although one option to help cut the cost may be to send your kids to a non-U.S. school, universities outside the U.S. are also not as affordable as they used to be.



Overall, the best strategy to saving for expat kids' college is not that different from saving for other long-term goals such as purchasing a home or for retirement. You will be better off if you:

- Start saving early
- Have a good idea of how much you will need
- Get in a habit of saving and investing regularly
- Design a diversified portfolio appropriate to your goal
- Seek to minimize the costs involved in investing

Additionally, minimizing taxes on your investment returns, including any interest, dividends, or capital gains, can be a real help. For dual-nationality expat couples, especially where one parent is a U.S. citizen, taxes need to be considered from several angles. These include:

- Tax owed in your country of residence
- Tax owed in the U.S.
- Potentially, tax owed in the non-U.S. spouse's home country

One of the following options may help expat parents save tax on their investments for the kids' college, especially for U.S. expat or dual-nationality couples.

Using U.S. 529 Plans to Save for College (for U.S. Spouses or Couples)

U.S. expat parents can save U.S. tax on college investments by using a vehicle called the Qualified Tuition 529 Plan (a "529 plan" for short). When contributing to a 529 plan, the earnings on contributions can build up on a U.S. tax-deferred basis. Furthermore, if the funds are later used for qualifying college costs (tuition, fees, books, supplies, and room and board), the earnings are U.S. tax-free. Not only can funds from 529 plans be used at any accredited university in the U.S., but they can also be used for many qualifying international schools.

The U.S. tax savings can be significant. In the example outlined in our previous blog post on 529 plans, we calculate that parents who save for college can meet the same college goal while saving 27.5% less per year using a 529 plan than if they don't use one.

529 Plan Advantages

- Best choice for dual-nationality couples where the U.S. spouse is using the U.S. married filing jointly tax status.
- Low-cost, tax-efficient way to have a professionally managed portfolio specifically designed for your kids' college goals.
- If one of your kids ends up not needing some or all of the funds, you can change the 529 plan beneficiary to pretty much any other college student, including yourself.
- Funds can be used for universities both inside the U.S., as well as many other international universities.

529 Plan Disadvantages

- Funds must be used for qualified college expenses (e.g., tuition, books, room and board). If funds are used for another purpose, U.S. tax penalties may apply.
- While 529 plans may save on U.S. tax, they may not be recognized as tax-advantaged vehicles in your country of residence. For U.S. expats to get tax benefits on a 529 plan, you'll want to be sure that your country of residence either (1) does not tax non-citizens on their offshore holdings or (2) that the local tax rate is lower than your U.S. rate.

Choosing a 529 Plan

In choosing among the many state-run 529 plans available, look for the following attributes:

- Low expenses: Seek plans that offer passively managed funds and low administration fees.
- A variety of investment options to choose from.
- An "age-based option," which means the plan will automatically adjust its asset allocation to be less volatile as your child approaches college age.

To help narrow the choices, check out the Saving for College website, which offers useful screening tools and other information, as well as Morningstar's 529 Plan Center.

Using an Offshore Portfolio to Save for College (for Non-U.S. Spouse or Couple)

In the case of a dual-nationality expat couple where one spouse is not a U.S. citizen, another U.S. tax saving option may be to have the non-U.S. spouse invest in a diversified offshore portfolio. This can work in cases where the American is using the U.S. head of household tax filing status and where the country of residence does not tax the non-U.S. spouse on their offshore investments. The offshore portfolio should be held at an offshore brokerage (not an insurance company). Devise a diversified portfolio appropriate for your goal using low-cost investments such as index funds or ETFs. Depending on the mix of nationalities involved, it may make sense to build your portfolio using investments that are domiciled outside of the U.S.

Offshore Portfolio Advantages

- Funds do not have to be used for college expenses. If for some reason your kids do not need the money for college, you can redeploy the savings to other goals without tax penalty.

Offshore Portfolio Disadvantages

- This option only provides a U.S. tax savings if the American parent is filing as "head of household." Otherwise, the offshore portfolio is subject to U.S. taxes, and punitive U.S. tax rules regarding Passive Foreign Investment Companies (PFICs) may apply.
- The funds must be owned and/or gifted to the non-U.S. spouse. If for some reason the marriage ends, the U.S. spouse may lose any decision-making over how the funds are used.
- You may need to set up and manage the portfolio, asset allocation, and investments yourself.

Setting Up an Offshore Portfolio for College Funding

To set up and manage an offshore portfolio with the goal of funding college, you must:

- Choose an appropriate offshore discount broker; see *"Five Questions Expats Should Ask Before Choosing an Offshore Custodian"* for details.
- Develop an investment allocation and portfolio consistent with the risk and time horizon of the college funding goal; see *"Seven Things Expats Need to Know About Investing"* for help.

Beware of Offshore Savings Schemes

Often, expat parents are pitched insurance-wrapped savings schemes or endowment plans, which are described as the best way for them to save for college or other long-term goals. These products are not the same as the offshore portfolio outlined above. Instead of using an offshore discount broker to purchase low-cost investments, "offshore savings schemes" are insurance-wrapped investments typically sold by offshore financial institutions. These schemes rarely make sense for expat parents for a number of reasons, including their long lock-in periods and the multiple levels of hidden fees that negate any tax savings. This last point is especially the case for U.S. expats, who may actually have to pay higher-than-usual taxes in the U.S. if they are using these offshore savings schemes to invest in what the IRS classifies as PFICs.

Get Started Early

Saving for a child's college education can be a major task for expat parents. Depending on your nationality, there are different approaches that may help you save on tax and make a greater percentage of your investments available to your kids for their college costs. It's important to get started early and put aside regular savings. In the case of dual-nationality couples where one person is a U.S. citizen, using either a U.S. tax-advantaged vehicle such as a 529 plan or an offshore portfolio may help put you ahead of the game.

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Five Questions Expats Should Ask Before Choosing an Offshore Custodian

For American Expat Parents: Using 529 Plans to Save for College

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American Expats: Don't Get Caught by U.S. Tax Rules on Foreign Investments

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