Expat Contributions to US Individual Retirement Accounts

The Good News: the Economic Growth and Tax Relief Reconciliation Act of 2001 (the Act) signed by President Bush last year increased the amount we can stash away into our traditional and Roth IRAs each year. The Bad News: many of us who work and live outside of the US either fail to take advantage of this retirement vehicle, or make contributions when not allowed to do so under current legislation. In this article I will cover the new IRA contribution limits, as well as what you can do to take advantage of IRAs if you work overseas.

Prior to 2002, if an individual received taxable compensation (wages, tips. commissions, etc) or alimony, a maximum of $2,000 a year could be contributed to an IRA. However, the Act increased this limit beginning in 2002 through 2004, so that the maximum contribution allowed was $3,000. In 2005 through 2007 the limit increases again to $4,000, and again to $5,000 from 2008 to 2010. As if this were not enough, the maximum allowable contribution will be indexed to inflation as of 2008, providing for future increases in the contribution limit.

Another new wrinkle in the law is the catch-up provisions available as of 2002 for those age 50 or over. If you have reached the half-century mark, the IRS allows an additional $500 to be contributed per IRA through 2005. This catch-up provision increases to $1,000 for taxable years beginning in 2006.

These new limits greatly expand the importance of the different IRAs in retirement planning. As a consequence, I fully expect that these tax advantaged vehicles will represent an even greater percentage of our retirement funds in the years to come.

Unfortunately, many American expats with earnings outside of the US are ineligible to contribute to IRAs. The Internal Revenue Code states that the maximum IRA contribution is the lesser of the allowable limit or 100% of taxable compensation. However, many expats with earnings abroad use the foreign earned income exclusion (See IRS Publication 54 for more information) to shelter all foreign earned income from US income taxes. Why pay US income tax when we don't have to, right?

However, by taking full advantage of the foreign earned income exclusion the option of an IRA contribution is precluded. In other words, if foreign earnings are at or below the exclusion limit ($80,000 in 2005) there is no taxable compensation. If there is no taxable compensation, we cannot contribute to an IRA.

To the extent that foreign earned income is above the exclusion limit, IRA contributions are allowed. Let us assume that foreign earnings were $100,000 in 2005. In this case US taxable compensation, after applying the foreign earned income exclusion, would be $20,000 (100,000 - 80,000 = 20,000). Because there is taxable compensation of at least $4,000, $4,000 can be contributed to an IRA.

What can be done if your income is below the foreign earned income exclusion? After consultations with Dale Walters, CPA, CFP of Cross-Border Tax & Accounting (dalew@keatsconnelly.com) in Phoenix, and the IRS office in Mexico City, the conclusion is that an IRA contribution is not possible if your income is at or below the exclusion limit.

Once in a while I run across people who have continued to make IRA contributions while also taking full advantage of the foreign earned income exclusion, reporting zero taxable compensation. These contributions are not allowed and a 6% excise tax would apply. If you find yourself in this situation, consider talking to your tax adviser about the possibility of reversing these deposits and their earnings.

A final point to consider is that for Mexican tax residents, income and capital gain distributions within IRAs are NOT free from Mexican income taxes. However, any taxes paid in Mexico could be offset on the US income tax return via the foreign tax credit.

The IRA is an important tax advantaged savings vehicle which has become more important over the years. It may be especially important to expats if their foreign employers do not offer retirement plans, but contributions must be made carefully in order to avoid the excise tax and possible disqualification by the IRS.

As always, please consult with your tax advisor before implementing any suggestions in this article.

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