Strategies for Canadians with U.S. retirement plans

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Canadian citizens who have lived and worked in the United States may own Individual Retirement Accounts (IRAs) and qualified retirement plans, such as 401(k) plans. When they return to Canada they may wonder what they should do with the money in these plans. Can they leave their money where it is? Can they move it to a Registered Retirement Savings Plan (RRSP)? What are the tax implications? This article explores some of the options and issues surrounding such questions, and discusses how to transfer traditional IRA[1] and 401(k) plan money to an RRSP.

Canadian residents, American citizens and green card holders

American citizens and green card holders are subject to U.S. tax law even if they don't live in the United States. This article discusses strategies for Canadian citizens and residents. Those strategies may not be appropriate for U.S. citizens or green card holders.

Features of IRAs and 401(k) plans

IRAs are similar to individual RRSPs. Generally, they aren't sponsored by employers.[2] A plan owner may acquire an IRA in several ways:

- By contributing to an IRA, just as a Canadian contributes to an RRSP.[3]
- By transferring their employer-sponsored qualified plan balance to an IRA after terminating from employment (the United States doesn't have the equivalent of a locked-in RRSP).
- By acquiring some or all of their spouse or common-law partner's IRA because of divorce or death of the spouse or common-law partner.

Like RRSPs, IRA balances grow tax deferred, and IRA withdrawals are taxed as income in the year withdrawn.

A 401(k) plan closely resembles a defined contribution pension plan.[4] Its name derives from the section of the Internal Revenue Code (IRC) that authorizes it. 401(k) plans are sponsored by employers who want to help their employees save for retirement. 401(k) plans may include employer matching contributions, though this isn't required. Employees may deduct their own contributions from income, and don't have to include employer contributions in income. Contributions grow tax deferred, just as they do in an IRA. There are limits to how much an employee and employer may contribute to a 401(k) plan. Though the limits are different from an IRA, generally (with minor differences that are beyond the scope of this article), 401(k) plans are subject to the same rules as IRAs.

Continuing tax deferral of Canadian-owned U.S. plans

Under the Income Tax Act (ITA) and the Canada – United States Income Tax Convention (the Treaty) Canadian residents may enjoy continued tax deferral of their IRA, 401(k) plan and Roth IRA[5] balances once they return to Canada, just as they would if they were still U.S. residents.[6] The deemed disposition and reacquisition rules under ITA section 128.1 do not apply to IRAs and qualified plans.[7]

Continuing tax deferral requires no action or election from a Canadian resident who owns an IRA (though not a Roth IRA). ITA clause 56(1)(a)(i)(C.1) exempts "foreign retirement arrangements" from tax "to the extent that the

[1] Throughout this article we will use the term "IRA" to refer to a traditional IRA, unless otherwise noted.
[2] A special type of qualified plan designed for small employers, a Simplified Employee Pension (SEP), uses employee-owned IRAs to which an employer makes contributions.
[3] The rules governing who may contribute to an IRA, how much they may contribute, and whether those contributions are deductible (and to what extent), are complex and beyond the scope of this article.
[4] 401(k) plans are only one type of qualified plan. There are different plans, such as 403(b) and 457(b) plans, but this article will discuss only IRAs and 401(k) plans unless otherwise noted.
[5] A Roth IRA is similar to a Canadian Tax-Free Savings Account (TFSA). Roth IRA contributions may not be deducted from income, but grow tax-free. As long as the withdrawal rules are obeyed Roth IRA withdrawals are tax-free. Under current law, Roth IRA balances may not be transferred to a TFSA or vice versa.
[6] Treaty, Article XVIII. Paragraph 81(1)(r) of the Income Tax Act (ITA) governs tax deferral of IRAs owned by Canadian residents. 401(k) plans owned by Canadian residents are treated as "U.S. pension plans" and are therefore "employee benefit plans" under ITA subsection 248(1) (CRA Document 9410515, dated September 28, 1994). As long as an election to defer tax is filed, income isn't recognized from U.S. pension plans until a withdrawal is taken.
[7] ITA subparagraphs 128.1(10)(a)(viii) and (x). These rules deem anyone who becomes a resident of Canada to have disposed of their property just before becoming a resident, and to have reacquired it at fair market value just after becoming a resident.

amount would not, if the taxpayer were resident in the country [i.e. the United States], be subject to income taxation in the country."[8]

The Canada Revenue Agency (CRA) has commented on this clause:

> Where the accrued income in the plan is not taxable under the Act until it is paid out of the plan, there is no benefit to an individual in making the election [under the Treaty to defer tax]. In this regard, there would be no need to make the election for a traditional IRA because the Act already provides for a deferral of taxation for these plans. A traditional IRA is characterized as a foreign retirement arrangement for Canadian tax purposes. Under clause 56(1)(a)(i)(C.1) of the Act, an individual is required to include amounts under a foreign retirement arrangement in income only when the amounts are paid out of the plan.[9]

Roth IRAs do not meet the definition of "foreign retirement arrangement" under the ITA and Regulations. Therefore, Canadians who own Roth IRAs must file a one-time election to defer tax on their plan balances. The CRA does not provide a form for making the election, but does provide guidance describing the election's required elements for Roth IRAs:[10]

- Plan owner's name and address,
- Plan owner's social insurance number and social security number,
- Name and address of the Roth IRA trustee or plan administrator,
- Plan account number,
- Date that the plan was established,
- Date that the plan owner became a resident of Canada,
- Balance of the Roth IRA as of December 31, 2008 or as of the date on which the plan owner became a resident of Canada, whichever is later,
- Amount and date of the first Canadian contribution made to the Roth IRA, if any, and
- A statement to the effect that the plan owner elects to defer Canadian taxation under paragraph 7 of Article XVIII of the Treaty for any income accrued in the Roth IRA for all taxation years ending before or after the date of the election, until such time as a Canadian contribution is made.[11]

Until recently, the Internal Revenue Service (IRS) provided Form 8891 for U.S. citizens and residents to elect continued tax deferral for their Canadian RRSPs and Registered Retirement Income Funds (RRIFs). Recent IRS guidance has rendered the form obsolete for most taxpayers.[12]

Non-resident tax treatment of a lump-sum withdrawal from an IRA or 401(k) plan

IRA and 401(k) plan lump sum withdrawals are subject to a 30% withholding tax. The IRC imposes this rate on most amounts that a nonresident receives from sources within the United States.[13] Taxable amounts include items like interest, dividends, salaries and wages, plus a catch-all category – "other fixed

[8] ITA clause 56(1)(a)(i)(C.1). ITA subsection 248(1) and Income Tax Regulation 6803 define a "foreign retirement arrangement" as a plan or arrangement to which subsection 408(a), (b) or (h) of the Internal Revenue Code (IRC) applies. Those subsections describe individual retirement accounts and individual retirement annuities (both referred to as IRAs), whether owned personally or in a custodial account.

[9] CRA Documents 2011-0404071E5 and 2015-0576551E5, dated June 25, 2012 and May 16, 2016. Although the CRA's interpretations of tax law can help taxpayers understand their obligations, such interpretations aren't legally binding on the CRA, and may be changed at any time. References to CRA publications and administrative decisions are included to help understand the CRA's thinking on the issues related to this article.

[10] Income Tax Technical News No. 43, September 24, 2010. An archived version is available at http://www.cra-arc.gc.ca/E/pub/tp/itnews-43/it-news-43-e.pdf.

[11] Ibid, "A Canadian contribution doesn't include rollover contributions from another Roth IRA or Roth 401(k) arrangement that qualifies as a 'pension' under Article XVIII of the Treaty. However, a conversion or rollover from qualified employer sponsored retirement plan accounts (such as traditional 401(k) plans and profit sharing plans) or traditional IRAs to a Roth IRA after December 31, 2008 will be considered a Canadian contribution."

[12] IRS Form 8891, available at http://www.irs.gov/pub/irs-pdf/f8891.pdf. This form has been rendered obsolete for most taxpayers: Revenue Procedure 2014-55, dated October 7, 2014, available at http://www.irs.gov/pub/irs-drop/rp-14-55.pdf. See also Internal Revenue Bulletin 2003-34 for further information on filing the election in the United States, available at http://www.irs.gov/irb/2003-34_IRB/ar14.html. The IRS notes that IRS forms and publications aren't binding on the IRS, and that the guidance contained in them is subject to change at any time. Private letter rulings issued by the IRS are binding on the Service only by the taxpayer who sought the ruling, and not anyone else. Such materials are included as a way to understand the IRS' thinking on the issues described in this article.

[13] IRC §871(a)(1)(A). See also IRS Document "Characterization of Income of Nonresident Aliens," last reviewed or updated February 10, 2017, at https://www.irs.gov/individuals/international-taxpayers/characterization-of-income-of-nonresident-aliens. The rate is reduced if a tax treaty applies.

or determinable annual or periodical gains, profits, and income" or FDAP. The IRS considers payments from "pensions and annuities" to be FDAP.[14] It has also confirmed that a lump sum withdrawal taken from a qualified plan by a Canadian citizen and resident would be treated as FDAP, and would be subject to the 30% tax rate.[15] It's reasonable to expect that the IRS would treat lump sum IRA withdrawals the same way.

To ensure that taxes imposed on nonresidents are paid, the IRC requires the financial institution disbursing funds to withhold 30% of the taxable amount, unless a tax treaty specifies a different rate.[16] Regarding pensions, the Treaty specifies a lower 15% withholding tax rate, but only for a "periodic pension payment".[17] Lump sum withdrawals and full surrenders aren't periodic, so they don't benefit from the lower 15% rate. To underscore this tax treatment, IRS Treasury Regulations specify that the manner in which FDAP is paid, lump sum or periodic, will not affect its withholding tax treatment.[18]

If a plan owner resident in Canada could benefit from the Treaty's lower 15% withholding tax rate, for example by starting to take periodic payments from their IRA or 401(k) plan, they would first need to file IRS Form W-8BEN: "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding" with the plan administrator or IRA trustee, and would need to provide their Social Security Number (SSN) or Individual Taxpayer Identification Number (ITIN).[19] Plan owners who don't have an SSN or ITIN may apply to the IRS for an ITIN using IRS Form W-7: "Application for IRS Individual Taxpayer Identification Number".[20] It's important to remember that while a plan owner could get the lower 15% Treaty withholding tax rate by taking periodic payments from their IRA or 401(k) plan, they would not be able to deposit those payments into their RRSP unless they had existing RRSP contribution room.[21] Taking periodic payments could therefore frustrate one of the strategies discussed later in this article – transferring money from an IRA or qualified plan to an RRSP on a tax-neutral basis.

If the withdrawal is the plan owner's only U.S. taxable transaction for the year, and if the appropriate amount of tax has been withheld, and as long as there's no penalty tax to pay (see below), the plan owner will not have to file a tax return with the IRS. The withholding tax will satisfy the plan owner's U.S. tax obligations. Unfortunately, if the correct amount of withholding tax has been applied to the plan owner's withdrawal, none of the withholding tax can be recovered from the IRS.

10% penalty tax

If the plan owner is under age 59½, an IRA or 401(k) plan withdrawal could attract a 10% premature withdrawal (or penalty) tax on the taxable amount, under IRC §72(t). The 10% penalty tax would be in addition to any withholding tax imposed on the withdrawal. In most cases, the taxable amount for an IRA or 401(k) plan withdrawal will be the entire distribution. IRC §72(t) provides many exceptions to the 10% penalty tax, but generally speaking, none of them apply to the type of lump sum withdrawal discussed in this article.[22] A plan owner who is under age 59½ and contemplating a withdrawal from their IRA or 401(k) plan should discuss the withdrawal with their independent tax advisor.

The financial institution disbursing funds to the plan owner will not withhold for the 10% penalty tax. Nor will the non-resident tax reporting slip the plan owner receives refer to the tax. But the lack of withholding or reporting will not exempt the plan owner from this tax. Instead, the plan owner will have to calculate their liability for the tax by

[14] IRS Document "Fixed, Determinable, Annual, Periodical (FDAP) Income," last reviewed or updated January 6, 2017, at https://www.irs.gov/individuals/international-taxpayers/fixed-determinable-annual-periodical-fdap-income.

[15] IRS Chief Counsel Memorandum dated July 11, 2007, PRESP-112729-07, UILC: 9114.03-06, at https://www.irs.gov/pub/lanoa/pmta01152_7324.pdf.

[16] IRC §1441. See also "IRS Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities", available at http://www.irs.gov/pub/irs-pdf/p515.pdf pages 17 and 20.

[17] Treaty, Article XVIII.

[18] Treas. Reg. §1.1441-2(b)(ii): "The fact that a payment is not made annually or periodically does not, however, prevent it from being fixed or determinable annual or periodical income (e.g., a lump sum payment)."

[19] Available at http://www.irs.gov/pub/irs-pdf/fw8ben.pdf.

[20] Available at http://www.irs.gov/pub/irs-pdf/fw7.pdf.

[21] ITA subparagraph 60(j)(i).

[22] IRC §72(t) provides many exceptions from the 10% penalty tax for pre-age 59½ distributions. Among them are distributions

- attributable to the plan owner being disabled (unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration, as per §72(m)(7)),
- part of a series of substantially equal periodic payments made not less frequently than annually for the plan owner's life or life expectancy, or for the joint lives or life expectancies of the plan owner and their designated beneficiary,
- taken to pay for medical expenses (subject to limits on amounts that may be withdrawn),
- made to satisfy obligations under a qualified domestic relations order (arising from marriage breakdown), or
- made for a first time home purchase.

completing and filing IRS Form 1040NR (and enclosing a cheque for the appropriate amount of tax).[23] If the plan owner is close to age 59½, they may want to consider postponing the withdrawal until after they have turned age 59½, to avoid the penalty tax.

Canadian tax treatment of IRA and 401(k) plan withdrawals

IRA and 401(k) plan withdrawals made by U.S. citizens or residents are taxed under U.S. law as income in the year of the withdrawal, even if growth in the plan has come from dividends or capital gains. The taxable withdrawal is the gross distribution, calculated before any withholding taxes, penalty taxes, surrender charges or fees are applied. Canadian residents must treat IRA and 401(k) plan withdrawals the same way for Canadian tax purposes.[24]

An exception to the U.S. rule applies to 401(k) plans (not IRAs) where the 401(k) plan owns shares in the company that sponsored the plan. The plan owner may withdraw such shares *in kind*, treating only the adjusted cost base in those shares as a taxable withdrawal. Any capital gain in the shares remains tax deferred until the plan owner sells the shares. At that time any gain in the share price will be treated as a long-term capital gain, regardless of how long the shares were in fact held before sale.[25]

A Canadian 401(k) plan owner with employer shares in their plan should speak with their independent tax advisor before initiating a transfer of any 401(k) plan money to an IRA or RRSP. 401(k) plan administrators may transfer only money, not shares, and will have to sell the shares in order to make the requested transfer. It's not certain that a Canadian resident would be entitled to this potentially valuable tax treatment, but if a Canadian resident were entitled, this favourable tax treatment would be lost if funds were transferred to an IRA or RRSP.

Foreign Tax Credit

The combination of U.S. non-resident withholding tax and Canadian income tax on the same IRA or 401(k) plan withdrawal creates a potential for double taxation. But a Canadian plan owner should be able to claim a foreign tax credit on their Canadian income tax return to reduce or eliminate the double taxation that could result.[26]

Under ITA section 126, a foreign tax credit is allowed as a "tax credit for foreign income or profits taxes paid by a resident of Canada … as a deduction from Canadian tax otherwise payable on that foreign income (see IT-270R)."[27] A Canadian plan owner may not claim a foreign tax credit for items like surrender charges and administrative fees that the institution holding the plan owner's IRA or 401(k) plan imposed on the transfer, only taxes.

The term, "foreign … taxes paid" refers only to the foreign taxes the Canadian plan owner was legally obligated to pay.[28] As discussed, if the U.S. financial institution holding the account withholds the appropriate amount of tax, the plan owner will not be able to recover any part of that tax from the IRS. The non-resident withholding tax will be the Canadian plan owner's final U.S. tax liability, and the IRS will not require the Canadian plan owner to file a U.S. tax return. In those cases, the CRA will accept a non-resident tax slip as evidence of the plan owner's foreign taxes paid.

But if the plan owner has to pay the 10% penalty tax, they may do so only by filing a Form 1040NR with the IRS, and paying the tax. In those cases, the plan owner's final tax liability will be established by their Form 1040NR return, not by a U.S. non-resident withholding tax slip. Also, if the plan owner was assessed a withholding tax rate higher than the correct rate, they may apply to the IRS for a refund, again by completing and filing IRS Form 1040NR. In both cases, the CRA will need a copy of the U.S. tax return before allowing the foreign tax credit.[29]

[23] IRS Form 1040 is the U.S. version of Canada's tax return, Form T1 General. IRS Form 1040NR is the U.S. non-resident tax return.

[24] The CRA's administrative position has long been that 401(k) plan distributions are included in Canadian taxable income under ITA subparagraph 56(1)(a)(i) while IRA distributions are included under ITA clause 56(1)(a)(i)(C.1): CRA Document 2004-0071271E5, dated July 13, 2004. However, in *Jacques v. The Queen*, 2016 TCC 245 Judge Graham determined that the 401(k) plan in issue was a savings plan, not a pension plan. This case is discussed later in this article.

[25] Unlike Canadian tax law, U.S. tax law distinguishes between short and long-term capital gains. Short-term capital gains are gains realized on the sale of a capital asset held for one year or less, while long-term capital gains are gains realized on the sale of a capital asset held for more than one year. Short-term capital gains are taxed as ordinary income, while long-term capital gains are taxed at the lower capital gains tax rate.

[26] ITA section 126. See also the CRA's Income Tax Folio, S5-F2-C1: Foreign Tax Credit, available at http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s5/f2/s5-f2-c1-eng.html .

[27] IT-506 – "Income Taxes as a Deduction From Income", page 1. An archived version is available at http://www.cra-arc.gc.ca/E/pub/tp/it506/it506-e.html.

[28] CRA Folio S5-F2-C1, Foreign Tax Credit, at http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s5/f2/s5-f2-c1-eng.html#tx-xmptncm.

[29] See instructions to CRA form T2209: Federal Foreign Tax Credits, at http://www.cra-arc.gc.ca/E/pbg/tf/t2209/t2209-15e.pdf.

According to CRA guidance, "the foreign tax credit is generally computed as the lesser of the foreign taxes paid and a proportion of the Canadian taxes paid. The proportion is the taxpayer's foreign income divided by the taxpayer's total adjusted income."[30] If the federal foreign tax credit completely offsets the foreign tax paid there is no need to consider a provincial or territorial foreign tax credit. Otherwise, a provincial or territorial credit is available to the extent of the tax remaining or the appropriate provincial or territorial limit, whichever is less.

An example may help explain how the credit works. If a plan owner, age 60, withdraws $100,000 from their IRA in a lump sum, the U.S. non-resident withholding tax will be 30%, or $30,000. We'll make the following assumptions for this example:

- The plan owner lives in Ontario.
- 2015 tax rates apply.
- The IRA withdrawal is the plan owner's only taxable U.S. transaction for the year.
- The U.S. financial institution deducts only withholding tax; it deducts nothing for items like surrender charges or early withdrawal fees.
- The Canadian and U.S. dollars are at par.[31]
- The plan owner earns $150,000 in income in addition to their IRA withdrawal.
- The plan owner contributes the $100,000 withdrawal to their RRSP (as we'll discuss later, the $100,000 withdrawal creates additional RRSP contribution room, in the same amount as the withdrawal. The contribution must be made by the normal RRSP deadline – 60 days after the end of tax year – or it will be lost. Plan owners who turn age 71 during the year must make the contribution by the end of the year.).
- In addition to the $100,000 RRSP deduction, the plan owner claims and qualifies for the following tax benefits:
  - The federal basic personal amount ($11,327 in 2015),
  - The provincial basic personal reduction ($9,863 in Ontario in 2015),
  - The Canada employment amount ($1,146 in 2015)
- The plan owner has no other deductions or credits that they can use to reduce their federal or provincial tax liability.

A $100,000 IRA withdrawal will increase the plan owner's Canadian income from $150,000 to $250,000, even though they received only $70,000 from their withdrawal after withholding tax. The plan owner borrows $30,000, and deposits $100,000 into their RRSP. The RRSP contribution entitles the plan owner to a $100,000 deduction, which reduces the plan owner's income to its original $150,000.

The plan owner's Canadian federal tax liability on $150,000 will be approximately $30,766, and their provincial tax liability will be approximately $17,234. The federal foreign tax credit is calculated as their foreign income amount divided by their total adjusted Canadian income, multiplied by the federal tax owing on their Canadian income. In this case, the federal foreign tax credit works out to $20,511 ($100,000 divided by $150,000 times $30,766). Because the U.S. withholding tax exceeds the federal foreign tax credit (by $9,489), the plan owner may use the provincial foreign tax credit to further reduce their tax bill. That tax credit is calculated the same as the federal tax credit: $100,000 divided by $150,000 times $17,234, or $11,490. Since $11,490 exceeds the plan owner's remaining tax liability ($9,489), the provincial foreign tax credit will be the lower amount. In this case, the federal and provincial foreign tax credits completely offset the U.S. non-resident withholding tax.

The foreign tax credit may not always completely offset a plan owner's U.S. tax liability. If the plan owner had taken their IRA withdrawal while still under age 59½, they would have had to have paid an additional 10% penalty tax to the IRS ($10,000 in this example). While the CRA would have allowed the plan owner to use the foreign tax credit to offset the penalty tax,[32] the plan owner would not have been able to claim enough of a foreign tax credit to offset their entire U.S. tax liability. The federal and provincial foreign tax credits would have totaled $32,000, leaving $8,000 of the U.S. tax liability uncovered.

Another note about the example: the plan owner's income was high enough that the foreign tax credit completely offset their U.S. tax liability. If the plan owner's income had been lower, they may not have been able to generate

[30] CRA Document 9634955, dated March 5, 1997.

[31] This is admittedly an unrealistic assumption. It is made to simplify the example by eliminating the need to note that particular items of income are in Canadian or U.S. dollars, or that an income item is the Canadian or U.S. equivalent of the other. When calculating a foreign tax credit for Canadian tax purposes, all amounts that are not received or paid in Canadian currency will have to be converted to Canadian dollars.

[32] CRA Document 2011-0398741I7, dated April 19, 2011.

a large enough foreign tax credit to entirely offset the U.S. withholding tax. Working with their independent tax advisor, the plan owner will need to estimate their tax bill for the year, to determine how much they can withdraw from their IRA or qualified plan, and still get a foreign tax credit that completely covers their U.S. withholding tax. The plan owner may want to spread the withdrawal over two or more years, taking care to make sure that their withdrawals don't resemble periodic payments.

In other cases, it may be possible to obtain a deduction under ITA subsection 20(12) for foreign income taxes paid, but for which a foreign tax credit is not available.

The CRA has dealt with a potential problem to using the foreign tax credit – that it can be used only to reduce tax on the same income. When the plan owner contributes the IRA or 401(k) plan withdrawal to their RRSP, the deduction eliminates the Canadian tax owing on the withdrawal. However, the CRA has said that, "in determining the proportion [of Canadian taxes paid], the foreign income isn't reduced by the deduction under paragraph 60(j) of the Act".[33] As a result, a foreign tax credit could still be available to partly or fully offset U.S. income tax arising from the withdrawal.

Only foreign tax credits applicable to foreign *business* income may be carried forward for use in future years. Foreign tax credits applicable to non-business foreign income (like IRA and 401(k) plan withdrawals) may not.[34]

On a final note, it may be possible, using a foreign tax credit or deduction, for a plan owner to reduce their taxes to the point where they would have to pay alternative minimum tax. The plan owner will need to discuss this, and other matters connected to this strategy and to using the foreign tax credit, with their independent tax advisor.

Required minimum distributions during the plan owner's life

As mentioned above, if a plan owner decides to not transfer their IRA or 401(k) plan balances to an RRSP, they can still maintain their plan balances tax deferred. But tax deferral doesn't last forever, on either side of the border. IRA and 401(k) plan required minimum distributions (RMDs) must begin by the end of the year the plan owner reaches age 70½. RMDs are similar to minimum formula distributions in Canada. But there's no requirement to transfer an IRA or 401(k) plan balance to an income vehicle like a RRIF. Instead, a plan owner withdraws the RMD (or more) by December 31st of the year they turn age 70½ and by December 31st of each year after that.

Right to delay first RMD

The first RMD may be delayed until April 1st of the year after the plan owner turns age 70½. But if the plan owner decides to delay taking the first RMD, they'll still have to take a separate RMD by December 31st of year 2, resulting in them taking (and paying tax on) two distributions in year 2.

Potential for confusion over age 70½ requirement

The age 70½ requirement causes confusion because a plan owner could get an extra year of tax deferral if their birthday falls after June 30th. For example, a plan owner born on any day from January 1 to June 30, 1947 will turn 70½ during 2017 and will have to take their first RMD by December 31, 2017 (or delay it until April 1, 2018). But a plan owner born on any day from July 1 to December 31, 1947 will turn age 70½ in 2018, and will have to take their first RMD by December 31, 2018 (or delay it until April 1, 2019).

The Canadian rules are less confusing. A Canadian RRSP owner born on any day in 1947 will have to take their first RRIF payment by December 31, 2019.

Calculating RMDs – Uniform Lifetime Table (ULT)

RMDs are calculated using one of two tables published by the IRS. The Uniform Lifetime Table (ULT) is the table most commonly used. It bases RMDs on the life expectancies of the plan owner and an imaginary beneficiary 10 years younger. The reason for using an imaginary beneficiary is to stretch distributions over a longer period than the plan owner's actual life expectancy. This results in lower minimum distributions than would result if only the plan owner's life expectancy were used, and therefore a greater likelihood that minimum distributions will last for the plan owner's actual lifetime. Although the ULT uses an imaginary beneficiary as part of its life expectancy calculation, there's no requirement that a plan owner using the ULT name any beneficiary to their plan, or that the beneficiary be a specific age.

[33] CRA Document 9634955, dated March 5, 1997.
[34] ITA section 126.

Calculating RMDs – Joint and Last Survivor Table (JLST)
A less commonly used table, the Joint and Last Survivor table (JLST), is used by plan owners whose *sole* beneficiary is a spouse *more than* 10 years younger. The JLST stretches distributions over a longer period of time than the ULT, and provides a greater likelihood that distributions will last for both spouses' lives. As you would expect, there are fewer circumstances in which the JLST table may be used, but those circumstances result in lower RMDs than the ULT produces for the same plan owner, and potentially longer distribution periods.

Once the correct table has been determined, calculations are based on the following factors:

- The age that the plan owner will attain by December 31st of the current year,
- The plan's account balance on December 31st of the previous year, and
- The actuarial present value (APV) of the account's future benefits.[35]

Actuarial present value of future benefits
The last element, the actuarial present value (APV) of the account's future benefits, requires some explanation. Some IRAs and 401(k) plans contain investments that offer an income or death benefit guarantee. An income guarantee allows the plan owner to take contractually specified withdrawals over their lifetime even if the investment's cash values have been depleted. A death benefit guarantee provides a minimum account value at the plan owner's death that could exceed the investment's actual value. Investments offering either guarantee contain contractual withdrawal limits that must be respected if the plan owner wants to rely on the guarantee.

In certain circumstances, plan owners must include the APV of these guarantees in their account values when calculating their RMDs. The APV of the guarantee is the sum of money needed today which, when invested using a reasonable interest rate, and using reasonable mortality assumptions, produces the money needed to satisfy the guarantee. Plan owners need not calculate the APV themselves. Rather, each year the institution providing the guarantee determines whether the law applies to the guarantee. If it does, the institution calculates the APV of the guarantee and advises the plan owner. The plan owner then adds the value of the guarantee to the account value and calculates their RMD accordingly.

Consequences for failing to take an RMD on time
The consequences for failing to take an RMD on time are severe – a penalty tax equal to 50% of the RMD the plan owner should have taken. And, of course, the plan owner will still have to take the RMD and pay income tax on it, plus interest on the tax that should have been paid for the year the RMD should have been taken. Unlike the case with RRIFs, U.S. law doesn't require the plan owner's financial institution to pay the RMD by the end of the year if it hasn't already been paid. Nor is there any requirement for a financial institution to pay the entire IRA or 401(k) plan balance to the plan owner after the end of the year the plan owner turns age 70½ if no distribution plans have been made by the end of that year.

Harsh as this penalty tax is, until recently its impact on a Canadian plan owner was worse. According to older guidance, the CRA allowed you to use a foreign tax credit to offset only U.S. *income* taxes, not penalty taxes.[36] However, the CRA has since decided that the 10% penalty tax is an income tax and that a plan owner may use a foreign tax credit to completely or partly offset it.[37] Since the 50% tax is also a penalty tax, the same reasoning may apply to allow a plan owner to use a foreign tax credit to completely or partly offset the impact of that tax as well. Again, a plan owner should consult with their independent tax advisor to make sure that they take RMDs on time and avoid the 50% penalty tax entirely.

Death of an IRA owner
If an IRA owner is subject to Canada's tax system and dies owning an IRA, the tax consequences depend on whether the plan owner had annuitized the IRA balance before death. This section discusses IRAs. 401(k) plans are discussed in the section below.

If annuitized
If the IRA owner had annuitized their IRA balance, and had named a beneficiary to receive any remaining payments after the IRA owner's death, the CRA will tax those payments if the beneficiary is a Canadian resident and subject to Canada's tax system, but only as the beneficiary receives them. Each IRA payment will be subject to the U.S. 15% non-resident withholding tax under the Treaty, and will be taxable in the beneficiary's hands for

[35] IRC §401(a)(9). Also see "IRS Publication 590, Individual Retirement Arrangements (IRAs)", available at http://www.irs.gov/pub/irs-pdf/p590.pdf.
[36] CRA Document 9330140, dated November 15, 1993.
[37] CRA Document 2011-0398741I7, dated April 19, 2011.

Canadian tax purposes.[38] The beneficiary will be able to use a foreign tax credit to offset some or all of the U.S. withholding tax.

If not annuitized

The tax treatment of an IRA that hasn't been annuitized is more complicated. Depending on the terms of the plan, an IRA may be treated as a "right or thing" at the IRA owner's death. A right or thing is income to which the deceased was entitled at death, but in fact never received, such as:

- Dividends that were declared on stock the deceased owned, but which weren't paid before death.
- Savings bond coupons that had matured and which could have been clipped and redeemed for cash, but weren't.
- Salary, commissions and vacation pay that the deceased had earned, but which weren't paid before death.

Under Canadian tax law, the executor of a deceased IRA owner has three choices for dealing with the money in the IRA:[39]

- Include the value of the IRA in the deceased's income for the year of death,
- Elect to file a separate return under ITA subsection 70(2), reporting only the deceased's rights or things on the separate return (resulting in potentially lower overall taxation), or
- Transfer the IRA balance to the deceased's beneficiaries under ITA subsection 70(3). Assuming the beneficiaries are Canadian residents, they would report income from the rights or things under ITA clause 56(1)(a)(i)(C.1) as they receive that income.

To take advantage of the tax deferral opportunities offered under the RMD rules, the executor would treat the IRA as a "right or thing" and choose the third option. The beneficiary has many options available for taking income, discussed in the section, "RMDs at the plan owner's death".

Death of a 401(k) plan owner

A 401(k) plan balance that has been annuitized with a named beneficiary to receive payments after the plan owner's death will be taxed the same as an annuitized IRA: payments will be taxed only as received.[40] 401(k) plans that haven't been annuitized will receive the same tax treatment as IRAs that haven't been annuitized, though for different reasons. 401(k) plans are treated as employee benefit plans under ITA subsection 248(1). Payments from such plans are only treated as income to the beneficiary in the year that the beneficiary receives them.[41] As with an IRA, the beneficiary may use a foreign tax credit to offset some or all of the U.S. withholding tax.

Under the Treaty, a Canadian resident doesn't have to recognize income from pension assets governed by U.S. law if an American citizen or resident wouldn't have to recognize income from those assets.[42] Therefore, a Canadian beneficiary of a deceased plan owner's IRA or 401(k) plan balance doesn't have to bring any money from the plan into income until the U.S. RMD rules require it.[43]

The combined effect of the rules in the ITA, CRA guidance and the Treaty is that a Canadian resident beneficiary of an IRA or 401(k) plan receives the same income tax deferral opportunities at the plan owner's death as an American citizen or resident, even if that tax treatment is more generous than that afforded to the beneficiary of an RRSP, RRIF or registered annuity.

RMDs at the plan owner's death

When the plan owner dies, the beneficiary's options depend on whether the beneficiary is a spouse or non-

[38] IT-499R – Superannuation or Pension Benefits, dated January 17, 1992, paragraph 9. An archived version is available at http://www.cra-arc.gc.ca/E/pub/tp/it499r/it499r-e.pdf. CRA Document 9800545, dated August 10, 1998 in part discusses the tax treatment of amounts received from an IRA that has been annuitized.

[39] CRA Document 9322935, dated November 26, 1993, CRA Document 9713295, dated July 10, 1997, and CRA Document 9800545, dated August 10, 1998 apply to IRAs.

[40] CRA Document 2000-0040385, dated October 17, 2000 in part discusses the tax treatment of amounts received from a pension plan that has been annuitized.

[41] CRA Document 9410515, dated September 28, 1994 and CRA Document 2001-0080855, dated June 21, 2001. This guidance applies to 403(b) plans, and by extension, to other U.S. qualified plans.

[42] Treaty, Article XVIII, paragraph 7.

[43] CRA Document 9800545, dated August 10, 1998.

spouse, and on whether the plan owner died before, on, or after their required beginning date (RBD).[44] The RMD rules at death are as follows: [45]

Death before RBD – non-spouse beneficiaries
The beneficiary may take:

- An immediate lump sum distribution.
- Lifetime distributions: Annuitize the IRA or 401(k) plan over life, with or without a guarantee period, or over a term certain period that doesn't exceed the beneficiary's remaining life expectancy (as measured by the RMD Single Life Expectancy Table (SLET)) for the year annuity payments begin. If a lifetime payout with guarantee period is selected, the guarantee period can't exceed the beneficiary's remaining life expectancy using the RMD SLET for the year annuity payments begin.
- Five year distributions: Take as little or as much as desired in any year (even nothing), as long as the entire IRA or 401(k) plan is distributed by December 31st of the year containing the fifth anniversary of the plan owner's death.
- Life expectancy distributions: Stretch distributions over the beneficiary's life expectancy using the RMD SLET, starting in the year after the plan owner's death, and subtracting one from life expectancy every year.[46] Distributions continue until the end of the beneficiary's life expectancy, whether the beneficiary lives beyond that date or dies before it.

Death on or after RBD – non-spouse beneficiaries
The beneficiary may take:

- An immediate lump sum distribution.
- Lifetime distributions: Annuitize the IRA or 401(k) plan over life, with or without a guarantee period, or over a term certain period that doesn't exceed the beneficiary's life expectancy. If a lifetime payout with guarantee period is selected, the guarantee period can't exceed the beneficiary's remaining life expectancy using the RMD SLET for the year annuity payments begin.
- Life expectancy distributions: Stretch distributions over the longer of
  - The plan owner's remaining life expectancy as of their date of death (using the RMD SLET), and subtracting one from life expectancy every year. Distributions continue until the end of the plan owner's life expectancy, whether the beneficiary lives beyond that date or dies before it, or
  - The beneficiary's own life expectancy (using the RMD SLET), starting in the year after the plan owner's death, and subtracting one from life expectancy every year. Distributions continue until the end of the beneficiary's life expectancy, whether the beneficiary lives beyond that date or dies before it.

Death before RBD – spouse is the sole beneficiary

- The surviving spouse may stretch distributions for their life using the RMD SLET, starting no later than the end of the year the plan owner would have turned age 70½, had they lived. The surviving spouse doesn't subtract one from life expectancy every year. Rather, they recalculate life expectancy each year, though continuing to use the RMD SLET. Distributions may continue for the surviving spouse's lifetime.

Death on or after RBD – spouse is the sole beneficiary

- The surviving spouse may stretch distributions in the same manner as a non-spouse beneficiary, using the RMD SLET: calculate remaining life expectancy starting in the year after the plan owner's death, and subtract one from life expectancy every year. Distributions continue until the end of the surviving spouse's life expectancy, whether the spouse lives beyond that date or dies before it.

Distribution options that don't depend on when the plan owner dies – spouse is sole beneficiary

- In addition to the two distribution options noted above, the surviving spouse may:
  - Take an immediate lump sum distribution.
  - Take lifetime distributions: Annuitize the IRA or 401(k) plan over the surviving spouse's life, with or without a guarantee period, or over a term certain period that doesn't exceed the surviving spouse's remaining life expectancy as measured by the RMD SLET for the year annuity payments begin. If a lifetime payout with guarantee period is selected, the guarantee period can't exceed the surviving

[44] The required beginning date is the latest date by which the plan owner must begin receiving RMDs. In most cases it's April 1st of the year following the year the plan owner turns age 70½.
[45] IRC §401(a)(9). Also see IRS Publication 590, Individual Retirement Arrangements, available at http://www.irs.ustreas.gov/pub/irs-pdf/p590.pdf for the IRS' explanation of the rules.
[46] The term "stretch" is used to describe distributions that are spread over a beneficiary's life expectancy, thereby "stretching" them over a longer period of time than is allowed under the lump sum or 5-year distribution options. Stretching also allows the beneficiary to keep the account in an accumulation phase as opposed to moving it into a payout phase.

spouse's remaining life expectancy as measured by the RMD SLET for the year annuity payments begin.

- Assume ownership of the deceased plan owner's IRA or 401(k) plan by:
  - Telling the financial institution that they'll be the new plan owner,
  - Transferring plan assets to their own IRA or 401(k) plan,
  - Creating a new IRA and transferring plan assets to it, or
  - If the deceased spouse's plan was an IRA, making a contribution to the deceased's spouse's IRA. Since only an owner may contribute to an IRA, the spouse will be deemed to have assumed ownership of the IRA by making a contribution to it.

No matter the method chosen to assume ownership of the deceased plan owner's IRA or 401(k) plan, the surviving spouse will own the IRA or 401(k) plan as if they had originally contributed to it. Accordingly, the contribution and distribution rules that applied to the deceased spouse will now apply to the surviving spouse. For example, upon assuming ownership of the deceased spouse's IRA or 401(k) plan, the surviving spouse won't be required to take RMDs until April 1st of the year following the year they attain age 70½, and will have the right to name a new beneficiary. Conversely, if the plan owner was under age 70½ at death, but the surviving spouse was over age 70½, the surviving spouse will have to start taking RMDs beginning in the year after the plan owner's death.

The RMD rules contain some other details:

- Only amounts distributed during the year are treated as income. Balances that haven't yet been distributed remain tax deferred.
- If the surviving spouse isn't the sole beneficiary of the IRA or 401(k) plan, they may not treat the IRA or 401(k) plan as their own. The surviving spouse will be treated as a non-spouse beneficiary.
- If an IRA or 401(k) plan owner dies before receiving all of their RMD for the year, the beneficiary must take the remaining RMD in the year the plan owner dies.
- A beneficiary who wants to take the deceased's remaining plan balance over their own lifetime or life expectancy must decide in time to receive their first distribution by December 31st of the year following the year the plan owner died.
- If a beneficiary takes more than their RMD in any given year, no credit is allowed to reduce the beneficiary's future RMDs.

Practical distinction between IRAs and 401(k) plans concerning distribution options at death
An IRA will offer all the distribution options for non-spouse beneficiaries that the law allows. 401(k) plans, while allowed to offer the same distribution options, *don't have to*. As a result, many 401(k) plans will offer a tax-free transfer of the plan balance to the surviving spouse at the plan owner's death. But when the surviving spouse dies, the plan administrator will send a cheque to whoever is named as the non-spouse beneficiary(s). The plan won't offer any distribution options that would permit greater tax deferral. A plan owner who wants to preserve tax deferral on 401(k) plan balances for their children, and who wants to keep the money in the United States, should confirm with the plan administrator that the appropriate distribution options are available, or consider transferring their 401(k) plan balance to an IRA.

Deduction for U.S. estate taxes

The preceding discussion about tax consequences at a plan owner's death has been confined to income taxes. However, the funds in an IRA or 401(k) plan are also "U.S. situs assets" for U.S. estate tax purposes. At the plan owner's death, their executor will have to file a U.S. estate tax return and report the plan owner's "U.S. situs assets" and their values at the plan owner's death, even if it turns out that there is no estate tax liability.[47]

Whether the plan owner's estate actually pays estate tax will depend on many factors, including the size of their IRA and 401(k) plan balances, and on the size of their world-wide estate. The estates of American citizens and residents may use a unified credit to reduce the estate tax they pay. Currently, the unified credit lets an estate pass up to US$5.49 million free from estate tax (2017 limit, adjusted annually for inflation). Under the Treaty, Canadian estates benefit from the unified credit in the same proportion that their U.S. situs assets bear to their world-wide estate. If 10% of the plan owner's world-wide estate was comprised of U.S. situs assets, their estate could use 10% of the unified credit to pass up to US$549,000 in U.S. situs assets free from estate tax.

[47] See our bulletin, "U.S. Taxes for Canadians with U.S. Assets", available at: https://www.sunlife.ca/advisor/v/index.jsp?vgnextoid=ad23575fb252f110VgnVCM1000009b80d09fRCRD&vgnextfmt=default&vgnLocale=en_CA&authgroup=SLFDEFPUB.

In the U.S. there's the potential for double taxation because IRAs and 401(k) plan balances may be subject to both estate and income taxes at the federal level. To help reduce or eliminate double taxation, a U.S. person beneficiary receiving distributions from a plan owner's IRA or 401(k) plan may deduct from those distributions any federal estate taxes paid and attributed to the IRA or 401(k) plan.

Until recently, the same tax relief wasn't available under Canadian law when a Canadian beneficiary took amounts from an IRA or 401(k) plan into income, even if part or all of the IRA or 401(k) plan balance was subject to U.S. estate tax.[48] But more recent CRA guidance suggests that those receiving pension payments from a deceased plan owner's U.S. pension may deduct U.S. estate taxes attributable to the pension plan.[49] A plan owner should check with their independent tax advisor about this potentially valuable tax treatment.

Options for Canadians owning IRAs or 401(k) plans

Canadian citizens returning to Canada have several choices for the money in their IRAs or 401(k) plans:

1. Withdraw the money in a lump sum

If the plan owner withdraws their IRA or 401(k) plan money after returning to Canada they'll have to include the entire withdrawal in income for Canadian tax purposes. The withdrawal also will be subject to 30% U.S. non-resident withholding tax, though the plan owner may be able to use a foreign tax credit to reduce their Canadian tax liability by some or all of the U.S. withholding tax.

But if the Canadian citizen withdraws the money while still a United States resident, the withdrawal will be subject to U.S. income tax rates that could be lower than Canada's and the U.S. non-resident withholding tax rate.[50]

Withdrawing money from an IRA or 401(k) plan may not be appropriate for younger plan owners, even if the plan owner could complete the transaction while still a U.S. resident. The loss of continued tax deferral plus ongoing taxation of investment growth at Canadian tax rates may offset any tax savings the plan owner may realize from withdrawing IRA or 401(k) plan money while still subject to the U.S. tax system. Also, the withdrawal may attract state income tax (unless before returning to Canada the plan owner was living in a U.S. state that did not charge personal income tax).[51]

However, those concerns may be offset by other factors. Canadian citizens returning from the United States may benefit from this strategy if they are:

- At or close to retirement,
- Age 59½ or older,
- Returning to Canada permanently,
- Holding a relatively small IRA or 401(k) plan, and
- Planning to use the money soon after returning to Canada, ideally in the same year that they return.

If the factors noted above apply, then taking a lump sum from an IRA or 401(k) plan before returning to Canada could make sense. It's important for plan owners to seek independent tax advice to help decide which strategy best serves their needs.

2. Transfer 401(k) plan money to an IRA; leave the IRA in place

This is a popular choice with U.S. citizens and residents when they leave an employer. IRAs offer continued tax-deferred growth potential, consolidation of assets into one account to reduce paperwork, flexible withdrawal and beneficiary options, and the ability to "stretch" IRA income across multiple generations. Most IRAs also offer more investment choices than a 401(k) plan, and access to more personalized investment advice. Moving money to an IRA can also be a good choice for plan owners who anticipate one day returning to the United States. The CRA regards a 401(k) plan-to-IRA transfer as tax-free after the plan owner has returned to Canada to become a Canadian resident.[52]

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[48] CRA Document 2003-0047151E5, dated March 3, 2004.

[49] CRA Document 2009-0313171E5, dated August 23, 2010. The plan the CRA was considering was a U.S. pension plan, but the reasoning could also apply to an IRA or 401(k) plan.

[50] Robert Keats, The Border Guide: A Guide to Living, Working and Investing Across the Border, 8th ed. 2007, International Self-Counsel Press, Ltd., pages 249-250.

[51] Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. New Hampshire and Tennessee impose a tax on dividends and interest income, but not on other types of income.

[52] CRA Document December 1991 – 126, dated, December 1991.

But this transfer may cause problems for Canadian residents because there's a difference of opinion among U.S. brokerage firms as to whether a non-resident may own an IRA containing securities like stocks and bonds or mutual funds. Some investment brokerage firms allow it while others don't, though the weight of opinion appears to be shifting towards not allowing it. The confusion arises because different institutions interpret U.S. securities laws differently. It's also possible that those firms currently allowing non-residents to maintain securities accounts may change their view. If the IRA is invested in non-securities accounts, like daily interest, certificates of deposit (CDs, the U.S. equivalent of a Guaranteed Income Certificate) or fixed interest deferred annuities, this discussion doesn't apply and the plan owner should be able to maintain an IRA in the United States. Still, a plan owner should check with the institution that will maintain the IRA before initiating a transfer. The transfer will also allow non-spouse beneficiaries to take advantage of continuing tax deferral if the plan owner's 401(k) plan doesn't.

3. Before returning to Canada, convert a traditional IRA to a Roth IRA, or transfer tax-deferred 401(k) plan assets to a designated Roth account in the 401(k) plan

Roth IRAs

Roth IRAs are similar to Tax-Free Savings Accounts (TFSAs). Under U.S. tax law, contributions to a Roth IRA aren't deductible, but withdrawals taken after age 59½ (and after five years have passed from the tax year for which the original Roth IRA contribution was made) are tax-free.

An individual may convert their traditional IRA to a Roth IRA.[53] There's no need to convert the entire traditional IRA in one transaction – conversions may be done over time. To the extent that the original contributions and growth being converted were sheltered from tax, the conversion brings those amounts into income for the year of the conversion. Once converted, and as long as the Roth IRA rules are respected, there should never be any tax on the contributions or growth in the Roth IRA.

There are no required distributions from a Roth IRA for the plan owner or spouse beneficiary at the plan owner's death. However, a non-spouse beneficiary will have to withdraw money each year from the Roth IRA using the RMD rules discussed above. There's no income tax on the amounts withdrawn, but there's a 50% penalty tax for missed withdrawals.

Designated Roth accounts in a 401(k) plan

401(k) plans may include a designated Roth account that offers many of the tax features a Roth IRA offers. Employee contributions to the designated Roth account aren't deductible, but plan assets grow tax-free. Withdrawals aren't taxed, provided again that the plan owner is over age 59½, and at least five years have passed from the tax year for which the original designated Roth account contribution was made. 401(k) plan contributing room remains the same whether contributions go to the designated Roth account or to the pre-tax deferral account.[54] Employer matching contributions to a designated Roth account aren't allowed.[55]

A 401(k) plan owner may transfer any amount from their plan's pre-tax deferral account to their plan's designated Roth account.[56] The rollover brings the rollover amounts into income for the year of the rollover. Individuals must check with their employer or plan administrator to make sure that their 401(k) plan offers a designated Roth account, and that it offers the rollover options discussed in this article. An individual must also make sure that they have enough money on hand to pay the tax generated from this transaction, as a 401(k) plan distribution while the member is still working for the sponsoring employer may not be available.[57]

Distributions from a 401(k) plan, even if all the plan's assets are in the designated Roth account, must begin no later than April 1 of the year following the year the plan owner turns age 70½, and must follow the RMD rules discussed earlier in this article. Those wanting continuing tax deferral may transfer their plan balances to a Roth

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[53] IRS Publication 590, "Individual Retirement Arrangements," available at http://www.irs.ustreas.gov/pub/irs-pdf/p590.pdf.

[54] $18,000 in 2017 plus $6,000 for employees age 50 and over. IRA contribution room is limited to $5,500: https://www.irs.gov/uac/newsroom/irs-announces-2017-pension-plan-limitations-401k-contribution-limit-remains-unchanged-at-18000-for-2017.

[55] See IRS guidance at http://www.irs.gov/Retirement-Plans/Designated-Roth-Accounts---Contributing-to-a-Designated-Roth-Account.

[56] See IRS Notice 2013-74, "In-Plan Rollovers to Designated Roth Accounts in Retirement Plans," available at http://www.irs.gov/pub/irs-drop/n-13-74.pdf.

[57] In service distributions can be obtained by loan, or by withdrawal if you become disabled, incur a hardship (because of an immediate and heavy financial need), or by attaining age 59½. Employers don't have to offer in service distributions, and, if they do, may impose more stringent restrictions on in service distributions of employer contributions than on distributions of employee contributions. In any event, withdrawing qualified money to pay the taxes due on a Roth IRA conversion or 401(k) plan rollover is generally not advisable. The money used to pay the tax is itself subject to tax, meaning that more money will have to be withdrawn. Further, money withdrawn from an IRA or 401(k) plan can't be re-contributed, so that the money and the tax-deferred or tax-free growth on that money won't be available in retirement.

IRA. However, the same restrictions discussed above that make it difficult or impossible for Canadian residents to own a traditional IRA in a U.S. brokerage account also apply to a Roth IRA. The restrictions don't apply to 401(k) plans, whether the plan contains pre-tax deferrals or designated Roth accounts.

Impact of the Treaty on Roth IRAs and designated Roth accounts
Under the latest amendments to the Treaty, Canada respects the tax deferral that both Roth options offer, provided the individual made their contributions while a United States resident, and elects to continue tax deferral once in Canada. Roth IRA and designated Roth account withdrawals that wouldn't be taxed in the United States won't be taxed in Canada provided the election noted above has been made.

Any Roth IRA conversion or 401(k) plan rollover to a designated Roth account should be done before the plan owner returns to Canada. If the plan owner waits until after becoming a Canadian resident, the conversion amount is included in income under Canadian law.[58] Further, the Treaty doesn't protect Roth IRA balances that result from a conversion done after 2008 while the individual is a Canadian resident.[59] The growth on those balances will be taxed each year.

Accordingly, if a Canadian citizen living in the United States knows in advance that they'll return to Canada, they may wish to do a Roth IRA conversion before leaving the United States, or move money from the pre-tax deferral account in their 401(k) plan to their plan's designated Roth account. In addition to benefitting from the Treaty's protection of the Roth balances from ever being taxed, they may also benefit from paying tax on the conversion at lower U.S. tax rates. Currently, the Treaty doesn't allow transfers of Roth IRA or designated Roth account balances to a TFSA, or vice versa. Roth IRA conversions and designated Roth account rollovers are complicated, and require the assistance of an independent tax advisor.

4. Leave the balance with the former employer's 401(k) plan
This option can also be a good choice for a plan owner who anticipates returning to live permanently in the United States at some point. Many 401(k) plans allow this option, but it's important to check with the plan administrator first. Some plans pay out small balances when an employee leaves the employer in order to relieve the plan administrator of the burden of administrating small accounts. Many 401(k) plans limit the deferral options available to non-spouse beneficiaries when the plan owner dies.

There are some advantages and drawbacks with this approach (these considerations apply to IRAs also, unless otherwise noted):

Advantages

- **IRA and 401(k) plan RMDs are lower than RRIF minimum formula distributions for plan owners age 72 and over.**[60]

Plan owner's age	RRIF minimum formula	RMD withdrawal
72	5.28%	3.91%
82	7.08%	5.85%
89	10.21%	8.33%

- **No requirement to convert from a retirement savings plan to a retirement income plan.** This eliminates the risk that the entire IRA or 401(k) plan balance could be forced into income in the year after the plan owner turns age 70½ through a failure to act in time.

- **15% Treaty withholding tax rate on periodic pension and annuity payments**. With the low Treaty withholding tax rate, it may be possible to use the foreign tax credit to fully or partly offset the Treaty withholding tax on IRA and 401(k) plan withdrawals.

- **Tax deferral may continue after the plan owner's death.** At the plan owner's death U.S. law allows a tax-free rollover of the plan balance to the surviving spouse and/or a non-spouse beneficiary. Some 401(k)

[58] ITA subsection 56(12).
[59] Ibid, note 7, Income Tax Technical News No. 43, p. 2, available in electronic format only at http://www.cra-arc.gc.ca/E/pub/tp/itnews-43/it-news-43-e.pdf.
[60] RRIF minimum formula distributions are calculated using the plan owner's age on January 1 of the distribution year. See IC 78-18R6, Registered Retirement Income Funds, available at http://www.cra-arc.gc.ca/E/pub/tp/ic78-18r6/ic78-18r6-e.html. RMDs are calculated using the age the plan owner will attain during the distribution year. See IRS Publication 590, available at http://www.irs.ustreas.gov/pub/irs-pdf/p590.pdf. The percentage distributions for RRIFs and RMDs have been adjusted so that they use the same ages for each distribution year.

plan administrators don't offer tax deferral to non-spouse beneficiaries. It's important to check with the plan administrator.

- **Canada's foreign asset reporting requirement.** IRAs and 401(k) plans are exempt from Canada's foreign asset reporting requirement. Roth IRAs are exempt if the plan owner has filed the Roth IRA election referred to earlier in this article. Canadian residents must disclose to the CRA any ownership interest they have in "specified foreign property" if the cumulative value of that property exceeds C$100,000. "Specified foreign property" is defined to not include an interest in an exempt trust.[61] An "exempt trust" is a "trust that is governed by a foreign retirement arrangement" (an IRA) and is also a trust exempt from tax in the country where it is resident, and established to provide retirement benefits in the form of an employee profit sharing plan (such as a 401(k) plan).[62] The CRA has also said that it considers Roth IRAs to be "specified foreign property", so Canada's foreign asset reporting rules apply to Roth IRAs unless the plan owner makes the election.[63] It's not clear from the CRA's guidance whether a 401(k) plan's designated Roth account is also subject to Canada's foreign asset reporting requirement, although the CRA does mention Roth 401(k) plans in its guidance.

- **No additional tax consequences.** Provided the plan owner complies with the CRA's election and reporting rules, IRA and 401(k) plan balances offer the same tax deferral as RRSPs and RRIFs. Distributions from IRAs and 401(k) plans are also treated the same as distributions from RRSPs and RRIFs.

- **Investments a plan owner will be familiar with.** Upon returning to Canada, a plan owner may continue the investment strategy that they were pursuing with their IRAs and 401(k) plans.

- **Minimal additional paperwork.** A plan owner need not file an election to maintain tax deferral for an IRA, but must file an election each year with the CRA to maintain tax deferral on their 401(k) plans. Only a one-time election is needed to preserve tax-deferral for a Roth IRA. They must also file Form W8-BEN with the financial institution holding their IRA or 401(k) plan before commencing distributions to receive the benefits of the 15% Treaty withholding tax rate. Otherwise, there are no additional paperwork requirements compared to those that a U.S. citizen and resident faces.

  Pension credit. A Canadian taxpayer age 65 and over during the year may use the pension credit to reduce or eliminate tax on up to $2,000 of "pension income". For those who will not turn age 65 during the year, the credit is only available for "qualified pension income". The rules governing what types of income qualify for pension credit treatment are complicated and beyond the scope of this article. However, IRA income does not qualify for pension credit treatment. It is not certain whether 401(k) plan income qualifies as "pension income".

Drawbacks

- **Where distributions are based on a younger spouse's age, IRA and 401(k) plan RMDs may be higher than RRIF minimum formula distributions.** Any advantage the RRIF enjoys will depend on the difference in ages, and will vary with age. The table below shows distributions using the age of a spouse 11 years younger than the plan owner. RMDs have been calculated using the JLST, which generates lower percentage withdrawal requirements than the ULT. But the JLST may be used only when the younger spouse is more than 10 years younger than the plan owner, and is the sole beneficiary of the plan owner's IRA or 401(k) plan.[64] A plan owner will need to talk with their independent tax advisor about which withdrawal regime produces higher or lower required withdrawals in their particular case.

Plan owner's age	Spouse's age	RRIF minimum formula	RMD withdrawal
72	61	3.33%	3.80%
82	71	5.00%	5.65%
89	78	6.17%	7.94%

- **Increased complexity.** A plan owner will need to keep current on two countries' tax laws governing their retirement plans, plus the Treaty rules. Those laws and rules could change. A plan owner will need professional advice on managing the tax issues. It may be easier for a plan owner to keep their money in

[61] ITA subsection 233.3(1) (see paragraph (n) of the definition of "specified foreign property").
[62] ITA subsection 233.2(1).
[63] Ibid, note 7, Income Tax Technical News No. 43, September 24, 2010, page 2.
[64] RMDs are calculated using the age the plan owner will attain during the distribution year. RRIF minimum formula distributions are calculated using the plan owner's age on January 1 of the distribution year. The percentage distributions for RRIFs and RMDs have been adjusted so that they use the same ages for each distribution year.

one place with one advisor, and subject only to Canada's tax laws.

- **U.S. estate tax.** A plan owner's heirs could lose some of the value of the IRA or 401(k) plan to estate taxes if the money is left in the U.S. As discussed above, the CRA has reversed its prior guidance, and may now allow Canadian beneficiaries to deduct from their IRA or 401(k) plan income that part of the U.S. estate tax attributable to the inclusion of the IRA or 401(k) plan in the deceased's estate.??

- **Foreign exchange rate risk.** IRAs and 401(k) plan assets are valued in U.S. dollars, even if the IRA or 401(k) plan is invested in "foreign" (e.g. non-U.S. dollar) assets. Fluctuations in the value of the U.S. dollar will affect the value of the IRA or 401(k) plan.

- **Penalty tax on late RMDs.** As mentioned above, the IRS levies a penalty tax equal to 50% of a late RMD. The RMD rules lack a rule similar to Canada's rule requiring the institution holding a RRIF to make at least a minimum formula distribution to the plan owner by the end of the year, even if the plan owner hasn't requested it. The RMD rules instead use a severe penalty to ensure compliance with the withdrawal rules. As mentioned above, the CRA allows a plan owner to use a foreign tax credit to partly or fully offset a U.S. penalty tax.

- **Earlier RMD commencement date.** RMDs must start no later than April 1st of the year following the year the plan owner turns age 70½, while RRIF payments may be deferred until the end of the year the plan owner turns age 72. Depending on whether the plan owner's birthday falls before or after June 30th, moving the plan money to an RRSP could result in an extra year or two of tax deferral. In considering this advantage, a plan owner must also consider whether, based on their individual circumstances, RMDs will be higher or lower than RRIF minimum formula distributions, and for how long.

- **A plan owner may not calculate RMDs using the age of the younger spouse unless that spouse is at least ten years younger.** In Canada, although plan owners must still use their age to determine when RRIF withdrawals must begin, the size of those withdrawals may be reduced if the plan owner bases them on the younger spouse's age. Again, a plan owner must consider whether, based on their individual circumstances, RMDs will be higher or lower than RRIF minimum formula distributions, and for how long.

- **Blackout periods.** Blackout periods occur when a 401(k) plan makes changes that require plan assets to be frozen while the changes are taking place. During a blackout period, plan participants may not make any changes to their 401(k) plans, or access their money. Neither IRAs nor RRSPs have blackout periods. Depending on the complexity of the task that has prompted it, a blackout period may last from a few days to several weeks. Plan participants receive advance notice of any upcoming blackout period.

- **Restricted investment options.** IRAs generally offer more investment choices than 401(k) plans. For non-residents, however, this advantage is partly offset by the fact that many institutions won't allow a non-resident to own securities in their IRA.

- **Restricted distribution options.** As mentioned above, 401(k) plans often limit the distribution options for non-spouse beneficiaries to a lump sum payment. IRAs offer all distribution options.

5. Transfer IRA and 401(k) plan balances to an RRSP

If a plan owner wants to exercise this option, they should expect to remain in Canada permanently, without a return to live in the U.S. While Canadian law allows a tax-neutral transfer of IRA and 401(k) plan money to an RRSP,[65] U.S. law doesn't allow a transfer of RRSP or RRIF money to an IRA.[66] Plan owners who believe that they may one day return permanently to the United States may wish to leave their plans alone and elect to defer Canadian taxation each year on those plans. Plan owners who expect to remain in Canada may wish to move their IRA and 401(k) plan money to an RRSP. With proper planning both types of transfers may be done on a tax-neutral basis without using any existing RRSP contributing room.

IRA to RRSP transfers

ITA subparagraph 60(j)(ii) governs transfers from an IRA to an RRSP. Only lump sum amounts (not periodic payments) contributed by the plan owner or spouse (and received by the plan owner because of the spouse's

[65] This article uses the term, "tax-neutral" to describe the transfer from an IRA or 401(k) plan to an RRSP because tax consequences may be avoided only with proper planning, not because the transaction is, in and of itself, tax-free.

[66] Private Letter Ruling 9833020, dated August 14, 1998. Private letter rulings are binding only on the IRS and the taxpayer who requested the ruling. However, like the CRA's advance income tax rulings, they provide an indication of the IRS' thinking on a particular tax topic.

death, or a divorce) to an IRA may be transferred to the plan owner's RRSP. Employer contributions to the plan owner's IRA may not be transferred to an RRSP unless the plan owner has enough existing RRSP contributing room to accept the employer contributions.[67]

The employer contributions restriction could cause problems for two types of IRA transfers to an RRSP:

- Simplified Employee Pension (SEP) IRAs. As discussed above (footnote 3), SEP IRAs are a form of pension plan available for employees of small businesses. Employers contribute directly to their employees' individually owned IRAs to fund their employees' pensions.
- Transfers of IRAs where the plan owner has transferred money to their IRA from a 401(k) plan to which their employer, or their spouse's employer, contributed.

However, the CRA has provided helpful guidance in both cases.

Considering the SEP IRA issue, the CRA has said that even though a SEP IRA uses an IRA as its funding vehicle, a SEP IRA is still a "pension plan", not a "foreign retirement arrangement" (i.e. an IRA).[68] Pension plans are governed by ITA subparagraph 60(j)(i), which allows the transfer of employer contributions to an RRSP. Therefore, even though a SEP IRA will contain employer contributions, it can still be transferred in its entirety to an RRSP.

Considering the presence of employer contributions in an IRA, the CRA has said that the transfer of a plan owner's 401(k) plan balance to an IRA is an opportunity to withdraw the money from the plan instead of transferring it. To the extent that a plan owner transfers their employer's 401(k) plan contributions to an IRA instead of withdrawing them, the employer contributions will be treated as contributions of the plan owner's own money to the IRA. As a result, the presence of money in an IRA that could be traced to an employer's contributions shouldn't present a problem when transferring that IRA money to an RRSP.

401(k) plan to RRSP transfers

As noted above, ITA subparagraph 60(j)(i) governs transfers from a "pension plan" to an RRSP. The CRA considers a U.S. 401(k) plan to be a "pension plan" under ITA subparagraph 60(j)(i).[69] But in *Jacques v. The Queen*, 2016 TCC 245, October 27, 2016, the Court ruled that amounts received from a plan described by the parties as a 401(k) plan were not superannuation or pension benefits under ITA subparagraph 56(1)(a)(i). The Court noted that there was no expert evidence to establish that the particular plan was a pension plan. In considering this decision it's important for a plan owner's independent tax advisor to confirm that the plan satisfies the requirements for transfer under ITA subparagraph 60(j)(i), and in particular, that it is a pension plan under ITA subparagraph 56(1)(a)(i). The CRA hasn't yet ruled on whether other types of U.S. qualified plans, like 403(b) and 457(b) plans, are eligible for a tax-neutral transfer to an RRSP.[70]

The CRA has said that it will allow a plan owner to transfer 401(k) plan money to an RRSP.[71] It also agrees that a plan owner can transfer 401(k) plan money to an IRA, and then transfer the IRA money to an RRSP.[72]

However, ITA subparagraph 60(j)(i) contains a restriction that affects pension plans but not IRAs: the pension plan contributions must have been made while the plan owner (or spousal contributor) was not a Canadian resident. The CRA will not allow a 401(k) plan transfer to an IRA, and subsequent transfer to an RRSP, if the transfer to the IRA was done to avoid the residency requirement.[73] This requirement could be troublesome for Canadians who worked for U.S. employers, participated in those employers' 401(k) plans, but remained Canadian residents throughout.

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[67] The ITA doesn't specifically exclude employer contributions to an IRA from transfer to an RRSP. Rather, ITA subparagraph 60(j)(ii) applies only to transfers of an "eligible amount". ITA section 60.01 defines an "eligible amount" as an amount received from a "foreign retirement arrangement", except for that part of the arrangement contributed by "a person other than the taxpayer or the taxpayer's spouse or common-law partner or former spouse or common-law partner." Since amounts contributed by an employer would fall within the "other than" part of the definition, employer contributions to an IRA may not be transferred on a tax-neutral basis to an RRSP. ITA subsection 248(1) and Regulation 6803 define a "foreign retirement arrangement" as an arrangement to which IRC §§ 408(a), (b) or (h) applies. Those sections all refer to IRAs.

[68] 2002 RRSP/RRIF Consultation Session, dated October 28, 2002, page 2.

[69] CRA Document 2004-0065161E5, dated June 1, 2004 and CRA Document 2004-0071271E5, dated July 13, 2004.

[70] CRA Document 2000-0053095, dated November 22, 2000. The CRA considered a contemplated transfer of money in a 403(b) plan to an RRSP, but felt that it did not have sufficient information to give an opinion.

[71] CRA Document 2015-0572541R3 (E), dated January 1, 2015.

[72] CRA Document 9805625, dated June 23, 1998.

[73] CRA Document 9641365, dated March 3, 1997.

Whether a plan owner transfers money from an IRA or 401(k) plan to their RRSP, they'll need to include in income the lump sum withdrawal from the IRA or 401(k) plan for Canadian income tax purposes. But they may deduct the income when they contribute the withdrawal to their RRSP, without using existing RRSP contributing room. While U.S. withholding tax will be taken from the withdrawal, the plan owner can use a foreign tax credit to reduce or eliminate their Canadian tax bill by the same amount.

An Example

Here is an outline of how a plan owner could do the transfer using an example of a Canadian resident who is over age 59½ and who owns an IRA or 401(k) plan worth US$100,000:

Residency issues

- If the plan owner is transferring a 401(k) plan balance, they must have been a U.S. resident for U.S. income tax purposes when the contributions to the plan were made.
- The plan owner must be a Canadian resident for Canadian income tax purposes when the transfer to the RRSP is made.
- The plan owner should regard their move to Canada as permanent, with no move back to the U.S. as a resident for income tax purposes.

Withdraw money – U.S. tax issues

- The plan owner takes a lump sum withdrawal from their IRA or 401(k) plan. There's no need to withdraw the entire amount at once. If the plan owner's plans and circumstances suggest that it would be better for withdrawals and transfers to take place over more than one year, they may be done that way. However, the plan owner will need to carefully structure the withdrawals in order to avoid an appearance that they are taking periodic payments. Although periodic payments from an IRA or 401(k) plan will attract only 15% IRS withholding tax, the payments will be income for Canadian tax purposes, and won't be eligible for deposit to the plan owner's RRSP[74] other than by using the plan owner's existing RRSP contributing room.
- The IRA trustee or 401(k) plan administrator will withhold 30% of the withdrawal for U.S. federal income tax purposes (if the plan owner hasn't already submitted IRS Form W-8BEN with the trustee or administrator, they'll need to include it with their withdrawal request documents). If the plan owner withdraws the entire US$100,000, and if the trustee or administrator charges no fees, the plan owner will receive US$70,000, with US$30,000 withheld for the IRS.

Canadian tax issues – RRSP contribution rules

- If the plan owner doesn't already have an RRSP, they'll need to create one.
- The entire US$100,000 withdrawal will be treated as taxable income for Canadian income tax purposes.
- The lump sum withdrawal will create additional "special" RRSP contributing room for the plan owner, in this case the Canadian equivalent of US$100,000 (the exact amount is determined by the exchange rate on the day the money is withdrawn). The additional contributing room allows the plan owner to contribute the withdrawal to their RRSP without using any existing RRSP contributing room.
- Unlike regular RRSP contributing room, the "special" RRSP contributing room created by a withdrawal from an IRA or 401(k) plan can't be carried forward to later years. If an amount up to or equal to the gross withdrawal isn't contributed to the plan owner's RRSP by the deadline, the special contributing room is lost.
- Contributions are allowed only to the plan owner's personal RRSP, not to a locked-in or spousal RRSP (even if the plan owner is the owner of the spousal RRSP), or to a RRIF.
- The plan owner will need to borrow the Canadian equivalent of US$30,000 or come up with that amount from other sources to bring the total contribution to their RRSP up to the Canadian equivalent of US$100,000. Having deposited this amount to their RRSP, the plan owner will be able to deduct it from income, thereby eliminating Canadian taxation on the withdrawal.

Contribution deadlines and restrictions

- Plan owners age 72 or older during the year may not use this strategy because they may not own RRSPs. The contribution may only be made to the plan owner's personal RRSP, not to a RRIF or annuity.[75]
- Plan owners turning age 71 in the year of the transfer must make the RRSP contribution before the end of the year that they make the withdrawal. If the plan owner misses that deadline, the withdrawal will be treated as taxable income in Canada with no offsetting deduction for an RRSP contribution available.

[74] ITA subparagraph 60(j)(i).
[75] CRA Document 2005-0110641M4, dated March 16, 2005.

- If the plan owner won't turn age 71 during the year, they must make the RRSP contribution no later than the 60th day following the end of the year the withdrawal was made. Again, if the plan owner misses that deadline, the withdrawal will be taxable income in Canada with no offsetting tax deduction.

Foreign tax credit

- The plan owner may use a foreign tax credit to partly or completely offset the US$30,000 IRS withholding tax against their Canadian income tax liability. If money was withheld from the plan owner's Canadian income on account of anticipated Canadian tax liability, they may receive a tax refund. They could use the refund to help repay the loan taken to top up the RRSP contribution, or to help replace other assets used for that purpose.

Some planning points

- Whether a plan owner will benefit from transferring IRA or 401(k) plan money to their RRSP will depend on the plan owner's individual circumstances.
- The plan owner must speak with their own independent tax advisor before initiating a transfer of IRA or 401(k) plan money to their RRSP. Such an advisor should be well versed in how IRAs, 401(k) plans and RRSPs work. The transfer requires advanced planning to make sure that it can be accomplished in a tax neutral way.
- If the plan owner decides to transfer IRA or 401(k) plan money to their RRSP, they may need to borrow to make up for the U.S. withholding tax, or may need to liquidate other assets. The plan owner should be prepared for this possibility in advance.
- If, after considering the withdrawal, the plan owner expects that they can't accomplish the entire transfer in one year, IRA or 401(k) plan withdrawals may be spread over as many years as needed to complete the transfer. Use of a non-business (individual) foreign tax credit may not be spread over more than one year.

Conclusion

A Canadian resident owning an IRA or 401(k) plan may leave the money where it is or move it to an RRSP. The choice requires careful consideration of many issues that the plan owner must discuss with a qualified independent tax advisor.

Any examples presented in this article are for illustration purposes only. No one should act upon these examples or information without a thorough examination of the tax and legal situation with their own professional advisors after the facts of the specific case are considered.

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