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 it 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 IRA and 401(k) plan money to an RRSP.[1]

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's IRA because of divorce or the spouse's death.

Like RRSPs, IRA balances grow tax deferred, and IRA withdrawals are taxed as income in the year withdrawn.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. Employees may deduct their own contributions from income, and don't have to include employer contributions in income. Many 401(k) plans offer an employer matching contribution, though this isn't required. 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's, 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 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]

Continuing tax deferral isn't automatic. Canadian plan owners must file an election each year with their Canadian tax returns to defer tax on their IRA and 401(k) plan balances. Curiously, the Canada Revenue Agency (CRA) provides no form or published guidance for plan owners wanting to make this election except for Roth IRAs.[7]

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[1] This article discusses options available for Canadian citizens and residents. American citizens, even if they live in Canada, and Canadian green card holders, must follow different rules not discussed in this article.

[2] A special type of qualified plan designed for small employers, called a Simplified Employee Pension (SEP), works by having the employer make contributions to employee-owned IRAs.

[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 401(k) plans.

[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) (see CRA Document 9410515, dated September 28, 1994). As long as an election to defer tax is filed, income isn't recognized from such plans until a withdrawal is taken.

[7] 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. 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.

The information required for the Roth IRA election is as follows:

- Plan owner's name and address,
- Plan owner's social insurance number and social security number,
- Name and address of the 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,[8] 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.

The Internal Revenue Service (IRS) provides a form for U.S. citizens and residents to use if they wish to elect continued tax deferral for their Canadian RRSPs and Registered Retirement Income Funds (RRIFs). Canadian plan owners wishing to file an election to defer Canadian taxation on their IRA and 401(k) plan balances may also want to consider the information that the IRS requires.[9]

The lack of a form or specific guidance on the election's contents doesn't exempt a plan owner from filing an election. Nor does it exempt them from taxation on IRA or 401(k) plan growth if they fail to file the election. It simply means that the plan owner must file an election without the benefit of a form or CRA guidance.

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

When a non-resident withdraws a lump sum from an IRA or 401(k) plan, the IRS requires the financial institution disbursing the funds to withhold 30% of the taxable amount, unless a tax treaty specifies a different rate.[10]

The treaty specifies a lower 15% withholding tax rate for "periodic pension payments". While this wording appears to exclude lump sum payments from the 15% withholding tax rate, the IRS regulation dealing with this issue says that "it is immaterial whether payment … is made in a series of payments or in a single lump sum".[11] As a result, any IRA or 401(k) plan withdrawal will qualify for the 15% withholding tax rate. Before making a withdrawal, the plan owner should confirm with the institution holding the funds that it will apply the 15% rate. Not all financial institutions know that the lower treaty rate applies to all withdrawals, and the only way to get a refund of any excess withholding tax is to file a U.S. non-resident tax return.

To take advantage of the treaty's lower withholding tax rate, the plan owner will 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 provide their Social Security Number (SSN) or Individual Taxpayer Identification Number (ITIN).[12] 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".[13]

If the withdrawal is the plan owner's only U.S. taxable transaction for the year, there's no need to file a tax return with the IRS. The withholding tax will satisfy the plan owner's U.S. tax obligations.

[8] Ibid, note 7, Income Tax Technical News No. 43, "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."
[9] IRS Form 8891, available at http://www.irs.gov/pub/irs-pdf/f8891.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, publications and private letter rulings aren't binding on the IRS, and that the guidance contained in them is subject to change at any time. Such materials are included as a way to understand IRS thinking on the issues described in this article.
[10] Internal Revenue Code (IRC) §1441. Also see "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.
[11] Treas. Reg. §1.1441-2(b)(ii).
[12] Available at http://www.irs.gov/pub/irs-pdf/fw8ben.pdf.
[13] Available at http://www.irs.gov/pub/irs-pdf/fw7.pdf.

10% penalty tax

If the plan owner is under age 59½, an IRA or 401(k) plan withdrawal could also attract a 10% premature withdrawal (or penalty) tax on the taxable amount under IRC §72(t). In most cases, the taxable amount will be the entire distribution. IRC §72(t) provides many exceptions to the 10% penalty tax, but none of them apply to the type of lump sum withdrawal discussed in this article.

It's not clear that the penalty tax applies to non-residents. Two sections in the IRC conflict on this issue. IRC §72 describes the tax treatment for IRA and qualified plan withdrawals, and imposes a 10% penalty tax on early withdrawals in the absence of an exception. IRC §1441 describes the tax treatment for distributions of U.S. source income to non-residents, and imposes only withholding tax. When a non-resident under age 59½ withdraws funds from an IRA or qualified plan, the two Code sections overlap.

In the absence of clear rules covering this situation, one approach may be to follow the rules that the IRS imposes on U.S. citizens and residents. If a U.S. citizen or resident takes a premature withdrawal from their qualified plan or IRA, the institution that reports the premature withdrawal will only report the fact of a premature withdrawal, and whether a known exception from the penalty tax applies. It won't calculate any tax owing, or withhold any money on account of the penalty tax. The taxpayer must calculate the penalty tax on their tax return, file the return, and pay any extra tax owing.

Non-resident reporting is different. The IRS requires the financial institution to use a different reporting slip. There's no place on the slip for the institution to characterize a distribution as premature. Nor does a non-resident taxpayer need to file a tax return.

One could argue that the IRS' failure to require financial institutions to report distributions as premature means that the penalty tax doesn't apply to a non-resident taxpayer. But this approach may carry significant risks. If the IRS determines that a non-resident owed the penalty tax, it could assess penalties and interest, in addition to requiring payment of the penalty tax. A different view is that the obligation to file a tax return and pay the penalty tax stems from the fact of the premature withdrawal, not from whether it's reported on an information slip, and not on whether the taxpayer is a U.S. citizen, resident or non-resident.

Of course, none of this discussion provides any relief from the fact that the IRS provides no guidance to help non-residents assess their potential liability for the penalty tax. Given this uncertainty, any plan owner under age 59½ who is contemplating a withdrawal from their IRA or 401(k) plan must discuss the contemplated withdrawal and the potential penalty tax liability with a tax advisor. If the plan owner is close to age 59½, they may even want to postpone the withdrawal until after they have turned age 59½, to avoid the issue altogether.

Canadian tax treatment of IRA or 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.[14]

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 the proceeds of sale greater than the adjusted cost base will be treated as a long-term capital gain, regardless of how long the shares were in fact held before sale.[15]

Canadian 401(k) plan owners with employer shares in their plans should speak with their tax advisors before initiating a transfer of any 401(k) plan money to an IRA or RRSP. A 401(k) plan administrator may transfer only

[14] 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.

[15] 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.

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. withholding tax and Canadian income tax on the same IRA or 401(k) plan withdrawal creates a potential for double taxation. But a Canadian taxpayer will be able to claim a foreign tax credit on their Canadian income tax return to reduce or eliminate the double taxation that could result.[16]

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)."[17]

A foreign tax credit may not necessarily equal the U.S. withholding tax because the credit isn't allowed as a one-to-one offset of U.S. taxes against Canadian taxes. Rather, as the CRA says, "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."[18] Accordingly, the plan owner will need to get tax advice to make sure that the foreign tax credit will completely offset the U.S. withholding tax.

A simplified example may help explain how the credit works. If the client withdraws $100,000 from their IRA, the U.S. withholding tax will be 15%, or $15,000. We'll assume in this example that the Canadian and U.S. dollars are at par, and that the client earns $100,000 in salary. Also, bear in mind that this example shows only how the federal foreign tax credit works. This article doesn't consider whether or to what extent a provincial foreign tax credit would apply. A $100,000 IRA withdrawal will increase the client's income from $100,000 to $200,000. Assume also that the Canadian tax otherwise payable is 25% of $200,000, or $50,000. The following formula determines the size of the federal foreign tax credit:

> Lesser of
>
> "withholding tax"
>
> and
>
> "foreign non-business income" divided by "worldwide income" multiplied by "Canadian tax otherwise payable"

Using the numbers referred to above, the formula is:

> Lesser of
>
> $15,000
>
> and
>
> ($100,000 / $200,000 x $50,000) = $25,000

Since $15,000 is less than $25,000, the client gets a foreign tax credit of $15,000.

As the formula implies, though, if the client reduces their Canadian tax otherwise payable, they could also reduce the size of their foreign tax credit, possibly to a level below the withholding tax. In the example above, a reduction in Canadian tax otherwise payable from $50,000 to below $30,000 would reduce the size of the foreign tax credit to less than $15,000. It's therefore important for the client to speak with a tax advisor to make sure that they actually qualify for a foreign tax credit large enough to eliminate the U.S. withholding tax.

[16] 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 .
[17] 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.
[18] CRA Document 9634955, dated March 5, 1997.

Unfortunately, foreign tax credits that can't be used in a given year are lost. They may not be carried forward for use in future years. Only foreign tax credits applicable to foreign *business* income may be carried forward. Foreign tax credits applicable to non-business foreign income (like IRA and 401(k) plan withdrawals) may not.[19] It's also possible to claim a deduction for foreign taxes paid, under ITA section 20. The interaction of ITA sections 20 and 126 is complicated, again highlighting the need for professional tax advice.

Finally, it may be possible, using a foreign tax credit or deduction, for a client to reduce their taxes to a point where they would have to pay alternative minimum tax. Again, the client should discuss this strategy with their tax advisor to confirm whether that possibility exists.

Required minimum distributions during the plan owner's life

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. 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 he or she turns 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. An example may help to clarify this issue. A plan owner born on any day from January 1 to June 30, 1945 will turn 70½ during 2015 and will have to take their first RMD by December 31, 2015 (or delay it until April 1, 2016). But a plan owner born on any day from July 1 to December 31, 1945 will turn age 70½ in the year 2016, and will have to take their first RMD by December 31, 2016 (or delay it until April 1, 2017).

The Canadian rules are less confusing. A Canadian RRSP owner born on any day in 1945 wouldn't have to take their first RRIF payment until December 31, 2017.

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 minimum distributions 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 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.

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 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 on the actuarial present value (APV) of the account's future benefits.[20]

[19] ITA section 126.
[20] IRC §401(a)(9). Also see "IRS Publication 590, Individual Retirement Arrangements (IRAs)", available at http://www.irs.gov/pub/irs-pdf/p590.pdf.

Actuarial present value of future benefits

The last element, the 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 the 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.[21] However, the CRA recently decided that the 10% penalty tax is an income tax and that a taxpayer may use a foreign tax credit to completely or partly offset it.[22] Since the 50% tax is also a penalty tax, the same reasoning may apply to allow a taxpayer 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 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 the IRA balance, and had named a beneficiary to receive any remaining payments after the IRA owner's death, the CRA will tax those payments only as the beneficiary receives them. Each IRA payment will be subject to the 15% IRS withholding tax, and will be taxable in the beneficiary's hands for Canadian tax purposes.[23] 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 (and this article assumes that that is the case). A right or thing is income to which the deceased was entitled at death, but in fact never received.

[21] CRA Document 9330140, dated November 15, 1993.
[22] CRA Document 2011-0398741I7, dated April 19, 2011.
[23] 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.

The following are examples of rights or things:

- 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:[24]

- 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). The beneficiaries 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 choose the third option.

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.[25] 401(k) plans that haven't been annuitized also 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.[26] 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.[27] 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.[28]

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.

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-spouse, and on whether the plan owner died before, on, or after his or her required beginning date (RBD).[29] The RMD rules at death are as follows: [30]

Death before RBD – non-spouse beneficiaries

- The beneficiary may take:
    - An immediate lump sum distribution.

[24] 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.

[25] 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.

[26] 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.

[27] Treaty, Article XVIII, paragraph 7.

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

[29] 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.

[30] 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.

- o 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 life expectancy. If a lifetime payout with guarantee period is selected, the guarantee period can't exceed life expectancy.
- o Five year distributions: Take as little or as much as desired in any year, 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.
- o Life expectancy distributions: Stretch distributions over the beneficiary's life expectancy using the RMD Single Life Expectancy Table (SLET), starting in the year after the plan owner's death, and subtracting one from life expectancy every year.[31] Distributions continue until the end of the beneficiary's life expectancy, regardless of 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 life expectancy.
  - 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, regardless of 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, regardless of 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 he or she 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, regardless of whether that 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 immediately above, the surviving spouse may:
  - Take an immediate lump sum distribution.
  - Take 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 life expectancy. If a lifetime payout with guarantee period is selected, the guarantee period can't exceed life expectancy.
  - 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.

[31] 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.

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, the spouse may not treat the IRA or 401(k) plan as his or her 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.

Deduction for U.S. estate taxes

The preceding discussion about tax consequences at the death of a plan owner has been confined to income taxes. However, an IRA or 401(k) plan balance may also be subject to U.S. estate taxes at the plan owner's death, even if owned by a Canadian resident.[32] In the U.S., there's the potential for double taxation because the same money may be subject to estate and income taxes at the federal level. To help reduce or eliminate this possibility, a 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.[33] 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.[34] A plan owner should check with their 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:

[32] 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.
[33] CRA Document 2003-0047151E5, dated March 3, 2004.
[34] 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.

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 withdrawal in income for Canadian tax purposes. The withdrawal also will be subject to 15% U.S. withholding tax, though the plan owner may be able to use a foreign tax credit to reduce or eliminate the withholding tax.

If the Canadian citizen withdraws the money while still a United States resident, the withdrawal will be subject to lower U.S. tax rates.[35]

Withdrawing money from an IRA or 401(k) plan may not be appropriate for younger plan owners, even if the plan owner completes 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.

However, those concerns may not matter if other factors exist. 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

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 professional 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, 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. This option can also be a good choice for plan owners who anticipate one day returning to the United States. But it 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.

The confusion arises because different institutions have different interpretations of U.S. securities laws. 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.[36] 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

[35] 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.
[36] IRS Publication 590, "Individual Retirement Arrangements," available at http://www.irs.ustreas.gov/pub/irs-pdf/p590.pdf.

the conversion. Once converted, and as long as the Roth IRA rules are respected, there will 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 member 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.[37] Employer matching contributions to a designated Roth account aren't allowed.[38]

A 401(k) plan member may transfer any amount from their plan's pre-tax deferral account to their plan's designated Roth account.[39] 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.[40]

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 member 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 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 resident of the United States, 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.

Any Roth IRA conversion or 401(k) plan rollover to a designated Roth account should be done before the client returns to Canada. If the client waits until after becoming a Canadian resident, the conversion amount is included in income under Canadian law.[41] Further, the treaty doesn't protect Roth IRA balances that result from a conversion done after 2008 while the individual is a Canadian resident.[42] 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 would also benefit from paying tax on the conversion

[37] $17,500 in 2014 plus $5,500 for employees age 50 and over.
[38] See IRS guidance at http://www.irs.gov/Retirement-Plans/Designated-Roth-Accounts---Contributing-to-a-Designated-Roth-Account.
[39] 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.
[40] 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.
[41] ITA subsection 56(12).
[42] 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/itnews-43-e.pdf.

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 a 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 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.**[43]

Plan owner's age	RRIF minimum formula	RMD withdrawal
72	7.38%	3.91%
82	8.99%	5.85%
89	11.96%	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 pension and annuity payments**. With the low U.S. withholding tax rate, it may be possible to use the foreign tax credit to entirely offset the U.S. 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) 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 doesn't apply to traditional IRAs and 401(k) plans.** 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.[44] 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).[45] Remember that the requirement to elect continued tax deferral, referred to above, still applies, even if the reporting requirement doesn't. Also, the CRA has said that it considers Roth IRAs to be "specified foreign property", so Canada's foreign asset reporting rules do apply to Roth IRAs.[46] 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

[43] 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.
[44] ITA subsection 233.3(1) (see paragraph (n) of the definition of "specified foreign property").
[45] ITA subsection 233.2(1).
[46] Ibid, note 7, Income Tax Technical News No. 43, September 24, 2010, page 2.

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 must file an election each year with the CRA to maintain tax deferral. 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 tax credit.** Anyone age 65 and over may use the pension tax credit to reduce or eliminate tax on up to $2,000 of "pension income". The taxable part of an IRA or 401(k) plan distribution 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.[47] A client will need to talk with their tax advisor about which withdrawal regime is higher or lower 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	8.15%	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 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. If the plan owner wants to leave the plan money in the U.S., the most common way of dealing with the potential added tax burden is to buy life insurance. A life insurance policy death benefit isn't included in a non-resident's estate for estate tax purposes (even if the policy was issued by a U.S. life insurance company) and can help make up for the beneficiaries any amount lost to estate taxes.[48] As discussed above, it appears that the CRA may have 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.

[47] 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.

[48] Under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, signed into law on December 17, 2010, U.S. estate taxes apply for 2011 and 2012, but with a maximum rate of 35% and a unified credit that exempts up to $5 million per person from estate taxes. Estates of those dying in 2010 may elect estate tax treatment under the old rules if they determine that those rules offer more favourable tax treatment. Under the treaty, only the deceased's "U.S. situs" assets will be subject to estate tax. Further, a Canadian estate may use only a proportionate amount of the unified credit. For example, if 25% of a deceased Canadian's assets were U.S. situs assets, their estate could use only 25% of the unified credit against any U.S. estate tax liability.

As mentioned above, the CRA has recently reversed its position on foreign tax credits, and appears ready to allow a taxpayer to use a foreign tax credit to partly or fully offset a U.S. penalty tax.

- **Earlier RMD commencement date.** RMDs must start by 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 his or her 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,[49] U.S. law doesn't allow a transfer of RRSP or RRIF money to an IRA.[50] 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. Two provisions in the ITA govern the transfer. ITA paragraph 60(j)(i) governs transfers from a "pension plan" to an RRSP, while ITA paragraph 60(j)(ii) governs transfers from an IRA to an RRSP. The CRA considers a U.S. 401(k) plan to be a "pension plan" under ITA paragraph 60(j)(i).[51] In both cases, if the rules are satisfied, and proper planning done, the transfer to an RRSP from an IRA or 401(k) plan may be done on a tax-neutral basis without using any existing RRSP contributing room.

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.[52]

Returning to an IRA or 401(k) plan transfer, under ITA paragraph 60(j)(ii) only lump sum amounts (not periodic payments) contributed by the plan owner or spouse 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.[53]

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[49] 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.
[50] 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.
[51] CRA Document 2004-0065161E5, dated June 1, 2004 and CRA Document 2004-0071271E5, dated July 13, 2004.
[52] CRA Document 2000-0053095. 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.
[53] 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

This restriction shouldn't cause problems for IRAs to which only the plan owner or spouse has contributed. However, it has the potential to cause trouble for SEP IRAs (a form of pension plan available for small employers) and IRAs where the plan owner has transferred money from a 401(k) plan to which their employer contributed. However, the CRA has provided guidance that helps deal with both issues.

Let's consider the SEP IRA first. The CRA says that even though a SEP IRA uses an IRA as its funding vehicle, a SEP IRA is still a "pension plan", not an IRA.[54] The restriction against transferring IRA money containing employer contributions to an RRSP under ITA paragraph 60(j)(ii) doesn't apply to transfers of pension plan money to an RRSP under ITA paragraph 60(j)(i).

Next, let's consider the 401(k) plan issue. The CRA regards a transfer of a plan owner's 401(k) plan balance to an IRA as an opportunity to withdraw the money from the plan instead of transferring it. To the extent that a plan owner transfers their employer's 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.[55] As a result, the presence of money in the IRA that could be traced to employer contributions shouldn't present a problem when transferring that IRA money to an RRSP.

The "employer contributions" issue still requires some attention, though. The CRA regards a 401(k) plan-to-IRA transfer as tax-free, even when the plan owner has returned to Canada to become a Canadian resident.[56] It also allows an IRA funded from a 401(k) plan to be transferred on a tax-neutral basis to an RRSP.[57] However, if the reason for transferring the 401(k) balance to the IRA is to allow a transfer of the employer contributions into the RRSP without having to use additional RRSP contributing room, the CRA could view the transfer as an avoidance transaction, and apply the general anti-avoidance rules, or GAAR.[58]

The CRA's reasoning on this point is curious, because an easy way to avoid the GAAR issue is to transfer the 401(k) plan balance directly to the RRSP instead of moving it through an IRA. Still, it would be best for plan owners to avoid the GAAR issue if they are contemplating a transfer of 401(k) plan money to an IRA. There are many good reasons for making such a transfer that have nothing to do with the CRA's concerns:

- A desire to consolidate different 401(k) plans into one account and reduce paperwork.
- IRAs generally offer more investment options than 401(k) plans.
- A plan owner can have access to individual investment advice with an IRA.
- An IRA offers tax deferral opportunities for non-spouse beneficiaries that many 401(k) plans are allowed to offer but don't.

It could also be an important factor if a considerable amount of time (such as several years) had passed between the transfer of the 401(k) plan money to the IRA and the transfer of the IRA money to the RRSP.

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. A deduction for contributing the money to the RRSP will eliminate the tax. The contribution won't use 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.

Of course, contributing the IRA or 401(k) plan withdrawal to an RRSP could be seen as eliminating the Canadian tax liability on the plan withdrawal. Taken at face value, this statement suggests a foreign tax credit wouldn't be available because there would be no "Canadian tax otherwise payable on that foreign income." 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".[59] As a result, a foreign tax credit should still be available to partly

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.

[54] 2002 RRSP/RRIF Consultation Session, dated October 28, 2002, page 2.
[55] CRA Document 9805625, dated June 23, 1998.
[56] CRA Document December 1991 – 126, dated, December 1991.
[57] CRA Document 9805625, dated June 23, 1998.
[58] CRA Document 9641365, dated March 3, 1997.
[59] CRA Document 9634955, dated March 5, 1997.

or fully offset U.S. income tax arising from the withdrawal, even though the RRSP deduction will have eliminated Canadian income tax on the withdrawal.

As a result, if done correctly, the transfer can be done on a tax-neutral basis.

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

- The plan owner must have been a U.S. resident for U.S. income tax purposes when the contributions to the IRA or 401(k) plan were made, and 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.
- The IRA trustee or 401(k) plan administrator will withhold 15% 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 to get the 15% tax rate). 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$85,000, with US$15,000 withheld for the IRS.
- Unless the plan owner has other U.S. income tax obligations, there's no need to file a U.S. tax return. The withholding tax will take care of the plan owner's obligations to 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 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$15,000 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, and the contribution may not be made to a RRIF.[60]
- 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.

[60] 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$15,000 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.
- If the transfer generates a higher foreign tax credit than the plan owner can use, the credit doesn't carry forward to later years. The risk of a wasted foreign tax credit is an important reason for why a plan owner needs to carefully plan the transfer in advance with their tax advisor, and may wish to spread the transfer over several years.

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 tax advisor.

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 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 substantial amounts to make up for the U.S. withholding tax, or may need to liquidate other assets. The plan owner needs to 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 foreign tax credit may not be spread over more than one year.

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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