Challenges Canadians face when transferring US retirement plans to an RRSP

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Canada and the US share many similarities including the longest international border between two countries. Due to the proximity of the two countries, many Canadians find themselves living and working in the US and contributing pre-tax dollars into employer-sponsored retirement plans such as the 401(k)[1] and Individual Retirement Account or IRA (collectively, US-based retirement plans). Once their US employment ends, many Canadian workers returning to their home country must eventually undertake the task of determining what to do with their US-based retirement plans as retirement age draws near (the Canadian retirees).

There are a variety of reasons why a Canadian retiree with a US-based retirement plan would endeavour to transfer or convert his 401(k) or IRA into a Canadian plan such as a registered retirement pension plan (RRSP). Some make the transfer to streamline their financial investments to just one country, increase access or expand the investment options available to them. Still, others are advised by their US plan administrator that their employer plans do not allow employee accounts to be held by non-resident aliens. Therefore, they are compelled to choose between liquidating their US retirement plan or transferring it over into a Canadian RRSP.

Whatever the reason, one key consideration when deciding whether to transfer a US-based retirement plan is the ability to claim foreign tax credits (FTC) for Canadian tax purposes on US withholding taxes (US WHT) paid as a result of such transfers or rollovers. Timing is key. While a Canadian FTC will generally be available for US WHT paid on amounts distributed from a US-based retirement plan, the timing and manner in which such distributions are made have direct consequences on whether all or just some of the US WHT amounts are fully utilized as FTCs on a Canadian tax return. Let's put it this way, FTCs in this regard are like a super-fast sports car: you could take it out for a spin and really feel the 350 horsepower kicking in to accelerate from 0 to 60 in 4 seconds, but if you do it during rush hour, what's the point? More on this later.

US 401(k) and IRA Savings Plans

A 401(k) is a statutory tax-deferred retirement plan that is similar to a defined contribution plan. Employer contributions to the plan are tax-deductible to the employer. Employee contributions are sourced from pre-tax monies and therefore reduce the employee's adjusted gross income base subject to US income taxes. Investment income accrued in the 401(k) account is tax deferred until cash distributions are made upon retirement.

IRAs are also statutory tax-deferred retirement accounts. However, unlike 401(k)s, an IRA is solely funded by an employee's contributions which are sourced from either pre-tax monies (traditional IRA) or after-tax monies (Roth IRA). Traditional IRAs are similar to 401(k)s in that all pre-tax contributions and income accruals in the account are tax-deferred until retirement. Roth IRAs are opposite – contributions are funded by after-tax monies, but income accruals in the account and distributions are tax-free.

Both kinds of the above US-based retirement plans are recognized in subsection 248(1) of the *Canadian Income Tax Act* (Act). For Canadian tax purposes, a 401(k) generally represents an 'employee benefit plan', while a traditional IRA represents a foreign retirement arrangement under *the Act*.

Tax Deferral in Canada

Generally speaking, the Canada-US Tax Convention (Treaty) entitles a Canadian tax resident to a tax-deferred treatment of income accrued in a 401(k) or an IRA for Canadian tax purposes in the same way that US tax residents are entitled to tax-deferred treatment of theirs until distributions are made from the plan. Indeed, Article XVIII(7) of the Treaty provides that income accrued by residents of Canada who are beneficiaries of a tax-exempt trust or another arrangement in the US that operated exclusively to provide retirement or employee benefits (i.e. a US retirement savings plan) may elect to defer taxation in Canada subject to rules established by the competent authority of Canada. The Canada Revenue Agency (CRA) has commented that deferral under the Treaty is not required for an IRA since this vehicle is a foreign retirement arrangement for Canadian income tax purposes, and as such, accrued income is inherently deferred under the Act and is only recognized into income when amounts are actually paid out.

US Withholding Taxes

Under Article XVIII (1) of the Treaty, the US has the first right to tax payments arising from US-based pensions and annuities. The term "pension" includes payments from other retirement arrangements and would include distributions from 401(k)s, traditional IRAs and Roth IRAs. Therefore, a Canadian resident who is a beneficiary of a 401(k) plan or an IRA would be subject to US WHT on the gross amount of the distribution from such US-based retirement plans.

The rate of US WHT is contingent on whether the payment is lump-sum or periodic. Generally, a lump-sum distribution would be subject to a flat 30 percent rate of withholding under domestic US tax laws. However, a distribution that qualifies as a "periodic pension payment" under Article XVIII (2) (a) of the Treaty would be subject to a reduced withholding rate of 15 percent (the Treaty rate). The question is what qualifies as a "periodic pension payment" for US tax purposes?

There is no bright-line definition of "periodic pension payments" under US domestic tax laws. However, US plan administrators will generally accept a 15 percent Treaty rate if a distribution is made in the form of installments paid over a period in excess of one year. We note in this regard that some tax practitioners have erroneously advised Canadian retirees that US tax laws will treat lump-sum payments from 401(k)s and IRAs as equivalent to periodic payments if a Form W-8BEN is filed with the US administrator. We do not agree with this interpretation of US tax laws. The Form W-8BEN is simply an administrative tool by which the US administrator can reliably associate a payment as being made to a non-US person and claim a reduced rate of withholding pursuant to a tax treaty with the US if any are applicable. Article XVIII (2) (a) of the Treaty makes clear that the Treaty rate of 15 percent for retirement plan distributions is only available for periodic payments, not lump-sum. Ultimately, the US plan administrators will be legally liable if it fails to withhold the correct amount of US taxes from the 401(k) or IRA distribution to the Canadian retiree, hence, they are generally very cautious and apply the 30 percent WHT rate, absent compelling evidence to the contrary.

Canadian retirees seeking to transfer their US 401(k) or IRA into a Canadian RRSP by rollover should pump the brakes and be cautious if considering taking periodic payments over lump-sum payments from their US-based retirement accounts. While the Treaty rate seems ideal, there is a significant speed bump to claiming this reduced 15 percent rate in this scenario. That speed bump arises because only lump-sum payments are eligible for a tax-deductible rollover into a Canadian RRSP under subsection 60(j) of

the Act, as is discussed further below.

Foreign Tax Credit

Generally speaking, amounts withdrawn from a 401(k) plan or an IRA by Canadian retirees are subject to Canadian tax, notwithstanding certain limited exceptions. For instance, amounts contributed to a 401(k) by a Canadian retiree who was enrolled under his US employer's plan while he was resident in Canada may be withdrawn as tax-free 401(k) distributions for Canadian tax purposes, provided the amounts were never claimed as deductions by the individual on his Canadian tax return. However, in a situation like that, there would be no availability of a Canadian FTC with respect to the US WHT deducted by the US plan administrator on the gross amount of distributions made to the Canadian retiree. Further, the distributions would not be generally tax-free for US tax purposes unless that Canadian retiree can establish that he was never a US resident while contributions and income accruals were made on his 401(k) account. But let's stick to FTCs.

Here comes a straightaway – time to hit the gas a bit. In an attempt to mitigate double taxation of foreign-sourced income, *the Act* contains a detailed FTC regime for Canadians with foreign-sourced income. An allowable FTC is a deduction from a taxpayer's Canadian tax otherwise payable and may be claimed in respect of foreign income or profits tax paid in the year. A separate FTC is calculated in regards to foreign investment income and business income as well as for each foreign country from which income was earned. The maximum amount of each FTC a taxpayer may claim is generally equal to the lesser of two amounts:

- The foreign income or profits tax (including withholdings taxes) paid for the year, and
- The amount of Canadian tax otherwise payable for the year that pertains to the applicable foreign income.

In order to claim an FTC from any particular country, the Canadian taxpayer must have applicable foreign income from that same country. If there is no foreign income for the purposes of the FTC, then there is no FTC.

As an example, assume a Canadian retiree is taking periodic withdrawals from his 401(k) plan on a regular basis. Let's assume that the threshold for the conditions to reduce the US WHT to the 15 percent Treaty rate is met (as previously discussed). To the extent the 15 percent US WHT satisfies any US tax liability, no US tax return needs to be filed.[2] For Canadian tax purposes, the gross withdrawal is included in this person's taxable income, on which income taxes are calculated. An FTC is then calculated in respect of the US income earned during the year (which includes the gross withdrawal) limited to lesser of the 15 percent US WHT and the amount of Canadian tax otherwise payable on that US-sourced income distribution.

Transfer from 401(k) to an RRSP

For sake of illustration, we will focus on a Canadian retiree with a 401(k) plan account, but note that slightly different rules exist for transfers from a 401(k) to an RRSP than from an IRA.

For a transfer of assets from a 401(k) to a Canadian RRSP, there is an automatic income inclusion for the amount of the withdrawal from the 401(k) for Canadian tax purposes. (However, *the Act* allows for a deduction in respect of pension benefits received in a lump-sum that is attributable to services rendered by the individual or his or her spouse when they were not residents of Canada). Since the deduction is to

facilitate transfer into an RRSP, the deduction cannot exceed the amount actually contributed to the RRSP (i.e. withdrawal net of US withholding tax). Therefore, in order to maximize the benefit of the deduction offered, an individual may need to top-up the RRSP contribution from other sources of funds to the extent the US withholding tax is applicable to the gross amount withdrawn. I never said this was going to be easy.

As an example, assume Mr. A is a Canadian resident and holds $100 in a 401(k) plan. Mr. A decides to transfer the entire balance of his 401(k) to his RRSP. On withdrawal from the 401(k) the plan administrator withholds $30 as US WHT paid. Mr. A then deposits the remaining $70 into his RRSP. On making the initial $100 withdrawal, Mr. A has an automatic $100 income inclusion for Canadian tax purposes as well as a deduction that is equal to and limited by the amount actually contributed to the RRSP, i.e. $70. However, Mr. A has the option of topping up the RRSP contribution from other sources of funds available to the extent of US WHT paid, i.e. $30. The result being that Mr. A could have an aggregate deduction equal to the amount automatically included, i.e. $100 in and $100 out of Mr. A's taxable income. If however, Mr. A only tops up an additional $10 to his RRSP, then he will have additional net income equal to the deficit of $20 on which he will be taxable.

A reasonable person might ask, "If the deduction above fully offsets the income arising on a transfer from a 401(k) to an RRSP, how can there be an FTC?" Fortunately, when calculating taxes otherwise payable on a source of foreign income for the purposes of determining the FTC, the calculation excludes the deduction allowed on transfer to an RRSP under subsection 60(j) of *the Act*. Therefore, in the case of qualifying amounts transferred from a 401(k) to an RRSP, the ceiling of the FTC claim is the Canadian tax otherwise payable on the gross amount that was withdrawn from the 401(k), ignoring the RRSP deduction taken.[3] This means that *the Act* allows an individual to calculate the taxes otherwise payable on income not even realized by the individual, giving a greater FTC than would normally be available. The reasoning behind this legislation can be puzzling if looked at in isolation. However, *the Act* appears to offer the individual an alternative to avoid double taxation by giving the person an FTC that they can apply against other Canadian sources of income such as employment, investment, or pension income. Without this relief, it would be like driving into oncoming traffic, there would be a mismatch of the taxable transactions: at the time of transfer for US tax purposes, and at the time of withdrawal from the RRSP for Canadian tax purposes.

Going back to Mr. A as an example. Assume at this point, that Mr. A has withdrawn $100 from his 401(k), had $30 withheld by the US plan administrator as US WHT and contributed the remaining $70 plus an additional $30 his mother gave him to his RRSP ($100 total). Mr. A has a resulting income inclusion and corresponding deduction equal to $100, i.e. the resulting net income is $nil. The FTC credit available to Mr. A is equal to the lesser of the $30 US non-resident withholdings taxes paid and the amount of Canadian taxes that would otherwise be payable on the $100 US sourced income inclusion. Assuming Mr. A is in the highest tax bracket and would otherwise pay over $30 in Canadian taxes for that $100 income inclusion, Mr. A's FTC is limited to the $30 actually paid. Mr. A's taxes payable are calculated on his net taxable income, i.e. without consideration of the $100 income inclusion. Mr. A is able to apply the $30 FTC determined against the taxes otherwise payable on his ordinary sources of income reducing his overall tax liability by $30 and possibly resulting in a refund for overpaid taxes. In this example, *the Act* has afforded Mr. A an FTC of $30 on income he has not been taxed on for Canadian tax purposes.

Accordingly, if an individual can arrange the transfer to occur prior to retirement, or at least when he still has significant Canadian sources of income, then he has an opportunity to significantly reduce his Canadian taxes otherwise payable for the year the transfer takes place. The effective result is full utilization of US WHT paid on the distributions as dollar for dollar credits against Canadian taxes on

other sources of income.

There are many sources out there that suggest a Canadian resident can make a transfer to an RRSP on a tax neutral basis, and they are not incorrect as is described above. However, what is usually left out of the discussion is if this transfer isn't done at the optimal time, with a little help from additional RRSP top-ups, then it likely won't be tax neutral at all, especially in the context of a 30 percent US withholding tax. Once again, the mechanics of the FTC calculation will only fully utilize the foreign taxes you have paid if you have enough other sources of income; otherwise, that nasty term that floats around could come to fruition…double tax!

Hopefully, that sports car analogy did not ruin your perception of FTCs. Now for a joyride into the sunset. In a future blog, I'll describe some more issues that Canadians need to be aware of when dealing with US-based retirement plans.

[1] Internal Revenue Code of 1986, as amended.

[2] The US Internal Revenue Service ("**IRS**") has an administrative policy that if a non-resident alien does not engage in a business or trade in the US, and has US income on which the tax liability is less than the withholding tax at source, then a US tax return need not be filed. *See,* IRS Internal Revenue Manual (IRM) § 3.21.3.3.4(2) – US Income Reporting Requirements (last revised Nov. 8, 2016); *see also*, https://www.irs.gov/individuals/international-taxpayers/taxation-of-nonresident-aliens (site visited March 6, 2017). This is generally good news: less filing equals less peoples' heads exploding. One important point to consider, however, is that if a tax return is never filed, then the clock for the statute of limitations never starts. For some, this is more significant than for others and as always it depends on a person's tax situation and risk appetite.

[3] See subsection (4) of the Act.