Canadian investment options for U.S. taxpayers residing in Canada

U.S. taxpayers[1] face several challenges when it comes to investing. Some Canadian investment products and vehicles carry negative U.S. tax implications. This article provides general tax guidance to help you navigate through this complex area and make informed decisions.

Canadian pooled funds

Pooled investment vehicles[2] are a popular form of investment. They aggregate contributions into a pool that is used to purchase a variety of investments. The investments typically sit in a Canadian legal entity such as a corporation or a trust. Investors own an interest in the Canadian entity and they receive their proportionate share of the entity's income and gains.

To deter U.S. taxpayers from parking investments offshore (often in tax havens), U.S. Congress enacted in 1986 the Passive Foreign Investment Company (PFIC) rules. These rules apply to U.S. taxpayers who own a non-controlling interest in a non-U.S. investment entity.[3] The rules are worded broadly enough to capture Canadian pooled investment vehicles.[4]

Where a Dual Taxpayer[5] owns an interest in such a vehicle, the Canadian and U.S. tax treatments are misaligned unless you file an election. Briefly, the PFIC rules treat current distributions as ordinary income. The preferential tax rate applicable to dividends and capital gains is not available. In addition, the rules apply the top marginal income tax rate, plus an interest charge on distributions of accumulated earnings and on gains from the disposition of fund units. The interest charge is compounded over the entire holding period.

Dual Taxpayers can elect Qualified Electing Fund (QEF) status instead.[6] This election provides better harmonization of the Canadian and U.S. tax treatments. You preserve capital gains treatment. Also, tax bracket rates are available on all distributions and dispositions, and the interest charge does not apply. The QEF election requires specific data from the fund administrator. It also entails greater complexity in your annual U.S. income tax return.

Sun Life issues the information required for you to file the QEF election for a great number of funds. Other fund sponsors also produce this information. Ask your financial advisor for a copy.

Pooled investment vehicles are powerful investment alternatives. They provide a level of diversification that would take significant dollars to replicate. Individual stocks and bonds typically do not qualify as PFICs. However, a portfolio of segregated securities can be very costly to maintain. In spite of the tax complexities outlined above, pooled investment vehicles are a wise investment alternative for many Dual Taxpayers.

Canadian investment accounts

Tax-Free Savings Account (TFSA)

Canadian residents aged 18 or older can invest in a TFSA. Income and gains earned in a TFSA are tax-free in Canada. Uncle Sam treats them differently. U.S. tax law treats TFSAs as non-registered accounts. Income and gains are subject to U.S. income tax. For many Dual Taxpayers this is not dramatic. With excess foreign tax credits, you can eliminate the additional U.S. tax. However, TFSAs are also subject to extensive U.S. reporting. U.S. tax law treats them as foreign trusts.[7]

Should Dual Taxpayers stay away from them? It depends on several factors. Relevant considerations include the rate of return that you expect to earn, your Canadian marginal tax rate and the professional fees that you will pay your U.S. tax accountant to comply. Let's look at an example.

Dual Taxpayer John has $60,000 invested in a TFSA. He earns an average 5% return, or $3,000 per year. Assume John has excess foreign tax credits available from previous years. As a result, John does not owe the U.S. government taxes because of the $3,000 income inclusion. John's U.S. accountant charges him $1,500 to complete the U.S. foreign trust forms. John's net return on investment is $1,500, or 50% lower than the gross amount. If John's Canadian marginal tax rate on this income is lower than 50%, he will have more money after-tax by investing in a non-registered account.

In time, the benefits associated with the TFSA may outweigh the costs for most Dual Taxpayers. After U.S. taxes and professional fees, the cumulative TFSA balance is not sufficient to provide a meaningful return currently. PFIC investments held in a TFSA are subject to the same rules as outlined above. No relief is available.

Registered Education Savings Plan (RESP) and Registered Disability Savings Plan (RDSP)

RESPs are used to save for the postsecondary education of a child. RDSPs are used to save for the long-term financial security of an individual with a disability. RESPs and RDSPs both accumulate income and gains Canadian tax-free.[8] U.S. law treats both as foreign trusts and their income is subject to U.S. taxation as it is earned. PFIC considerations apply here as well.

In March 2020, the IRS announced relief that extends to RESPs and RDSPs. While the plan income and gains remain taxable, the foreign trust reporting obligation for the subscriber is relaxed[9] where certain conditions are satisfied. The plan must limit contributions to US $10,000 annually or US $200,000 on a lifetime basis.

With a lessened reporting burden, RESPs and RDSPs are more cost-effective to Dual Taxpayers than TFSAs. Still, every taxpayer's situation is different. If your family unit includes Dual Taxpayers and non-U.S. taxpayers, consider registering RESPs and RDSPs in the name of a non-U.S. taxpayer. Provided the non-U.S. taxpayer contributes, the Dual Taxpayer parent or sponsor will not incur U.S. tax consequences.

RESPs and RDSPs can be setup for the benefit of a Dual Taxpayer child or disabled person. The U.S. tax consequences will vary based on the status of the sponsor and contributor. In general, a Dual Taxpayer beneficiary will have tax and reporting obligations when distributions commence. You should seek professional advice.

Registered Retirement Savings Plan (RRSP) and Registered Retirement Income Fund (RRIF)

The U.S. tax authorities recognize Canadian RRSPs and RRIFs as tax-favored vehicles. Dual Taxpayers can save for retirement using an RRSP without incurring Canadian or U.S. income tax. RRSPs and RRIFs are subject to limited U.S. reporting.[10] Fortunately, the foreign trust reporting does not apply.

Since RRSPs and RRIFs are U.S.-tax exempt, pooled investment funds will not directly trigger the PFIC rules. Pooled investment funds are generally safe inside an RRSP or RRIF.[11] However, Dual Taxpayers should be mindful of non-spousal bequests and beneficiary designations in favor of Dual Taxpayers. Consider selling the pooled investment funds while the account is registered. Personal (non-group) RRSP contributions by Dual Taxpayers are not deductible for U.S. tax purposes. You should exercise caution before making a large, catch-up contribution to your RRSP in any one year. You may owe U.S. taxes as a result.

RRSPs and RRIFs are Dual Taxpayer friendly. The U.S. tax implications are minimal relative to other investment vehicles. You should make extensive use of them, if in line with your financial goals.

Life insurance

Similar to Canada, U.S. law assesses life insurance products to decide if they meet tax-exempt treatment. Products that are more in the nature of investment products are not exempt. While the spirit of the U.S. rules is similar to our Canadian rules, the tests vary substantially. As a result, a product can be Canadian-tax exempt and U.S. taxable. The reverse is also true.

The greater the investment growth potential, the greater the risk that the policy will be U.S. taxable. A life insurance product that is not tax-exempt is subject to U.S. tax annually on the policy growth. Term products are U.S. tax exempt because they do not accumulate value. It is a question of fact whether whole life, universal life and participating products are exempt or not.

Canadian insurers do not test products for compliance with U.S. tax rules. Conversely, U.S. insurers do not test products for compliance with Canadian rules. This leaves Dual Taxpayers with risk and uncertainty. You will need to discuss your policies with your U.S. tax advisor, who will likely recommend that you also speak with an independent actuary for advice.

If your family unit includes Dual Taxpayers and non-U.S. taxpayers, consider placing the ownership of policies on the lives of Dual Taxpayers in the hands of a non-U.S. taxpayer. The incidents of ownership in the policy will rest with the non-U.S. taxpayer.[12] Also, one must consider what happens if the non-U.S. owner dies first.

It is not clear whether ownership by a Canadian corporation would escape the U.S. exemption tests.[13] Since dividends from the Capital Dividend Account (CDA) are U.S. taxable to Dual Taxpayers, this strategy is typically not favored. Ownership via a Canadian trust, including an Irrevocable Life Insurance Trust (ILIT), may also be ineffective to satisfy the U.S. exemption tests. This is because ownership of the trust assets may be attributed to the Dual Taxpayer under U.S. income tax law.[14]

Life insurance is a very challenging tool for Dual Taxpayers. Canadian and U.S. tax laws do not harmonize well. Unless you elect term coverage, you should work with a tax professional to analyze the cross-border tax consequences of your insurance strategy.

U.S. investment accounts

Some Dual Taxpayers wish to use accounts situated in the United States to meet their investment and retirement needs. Securities laws prevent most U.S. investment advisors from providing investment advice to Dual Taxpayers.[15] The licensing rules that apply to retirement accounts[16] are more flexible. You may keep your retirement funds in the United States but you should refrain from contributing additional dollars while you reside in Canada.

For more information on retirement planning with U.S. retirement accounts, please see our article entitled **Retiring in Canada with U.S. benefits**. If you are contemplating a transfer of your U.S. retirement accounts to Canada, see our article entitled **Strategies for Canadians with U.S. Retirement Funds**. Consult your tax advisor for details.

Conclusion

Investment planning for Dual Taxpayers is subject to many challenges. You must analyze products and vehicles carefully. With the support of your tax and financial advisors, you can find the right investment solutions for you.

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[1] For purposes of this article, these include American citizens and green card holders. This article is concerned with U.S. taxpayers who reside in Canada. U.S. taxpayers residing in the United States should seek investment advice and solutions in the U.S.
[2] These include mutual funds, pooled funds, hedge funds, corporate class funds, exchange-traded funds and segregated funds, to name a few.
[3] "Investment entity" means that the majority of the entity's assets produce passive income or that 75% or more of the entity's income is passive in nature. The PFIC rules are complex. Their particularities are beyond the scope of this article.
[4] Note that ETFs that are set up as a U.S. domestic entity and listed on a U.S. stock exchange are not PFICs.
[5] Through the remainder of this article, a Dual Taxpayer refers to a U.S. taxpayer (see note 1 above) who resides in Canada. These individuals are subject to both the Canadian and U.S. tax systems. They must report and comply in both countries.
[6] Another election, called Mark-to-Market, also exists under U.S. law. It typically does not harmonize the Canadian and U.S. tax treatments. It also does not preserve the tax-favoured treatment of capital gains. As a result, it is seldom used in practice and it is not discussed in this article.
[7] As such, a Dual Taxpayer needs to file IRS Forms 3520 and 3520-A annually.
[8] During the accrual period. Distributions of income and gains, as well as government grants, are taxable.
[9] IRS Forms 3520 and 3520-A, specifically. Treasury Form FinCEN114 and IRS Form 8938 are still required to disclose RESPs and RDSPs as foreign financial accounts.
[10] Treasury Form FinCEN114 and IRS Form 8938.
[11] There may be different interpretations among tax advisors as to whether the PFIC rules apply. You should speak with your U.S. tax advisor.
[12] These include the right to take a policy loan, to pledge the policy as security for a loan, to change the beneficiaries (unless irrevocable) and to cancel the policy, to name a few.
[13] This is because a non-exempt policy's growth may be includible in subpart f income. You should speak with your U.S. tax advisor for further advice.
[14] By virtue of the U.S. grantor trust rules. These are to be distinguished from the U.S. estate tax rules. ILITs are typically effective at sheltering assets against U.S. estate tax.
[15] This is because licensing regulations typically extend to residents of a given jurisdiction, irrespective of their citizenship.
[16] Such as Individual Retirement Accounts (IRAs) and 401(k) plans.