Sun Life

Strategies for Canadians[1] with U.S. retirement funds

If you've ever worked in the United States, you may own an Individual Retirement Account (IRA)[2] or a U.S. qualified retirement plan, such as a 401(k).[3] Should you leave the funds in the U.S.? What happens if you repatriate the funds to Canada? Can you preserve the tax deferral until you retire? This article explores a few options, including how to transfer IRA and 401(k) plan balances to a Canadian Registered Retirement Savings Plan (RRSP).

Leaving the funds in the U.S.

If you anticipate returning to live permanently in the United States sometime in the future, leaving the funds in your current U.S. plan may be a good option for you. However, consider checking with your plan administrator first, as there are many reasons a plan administrator may request that you take your money out. These reasons can range from legal constraints to mere administrative inconvenience, such as an account balance being too low.

Funds in a U.S. IRA or 401(k) plan grow free of Canadian and U.S. income tax. If you choose to keep your IRA or 401(k) plan, the tax deferral is preserved. But, as with Canadian retirement plans, the tax deferral won't last forever. With a U.S. IRA or 401(k) plan, you're required to start taking distributions when you reach age 72.

Periodic distributions from an IRA or 401(k) plan are subject to U.S. withholding tax at the rate of 15%.[4] If you start taking distributions when you're under age 59½, those periodic distributions will attract an additional 10% early withdrawal tax on top of the preceding rate.

Periodic distributions from an IRA or 401(k) plan are also subject to Canadian income tax in the year that you receive them. They are treated as pension income. To prevent double taxation (i.e. Canadian plus U.S. taxation) of the same income, Canada should grant you a credit[5] for the tax you paid to the United States, including the 10% early withdrawal tax, if applicable. As a result, you pay no more, in aggregate, than customary Canadian income taxes on your IRA or 401(k) distributions.[6]

Maintaining an IRA or 401(k) plan entails keeping current on tax laws in two countries. As laws and rules evolve over time, we recommend you seek professional advice periodically.

Repatriating the funds to Canada

Some people feel more comfortable keeping their money in one place, and subject only to Canada's laws. Others will wish to use their IRA or 401(k) plan assets to fund a short-term project. Whatever your reasoning, you may wish to liquidate your IRA or 401(k) plan and repatriate the funds to Canada.

An IRA or 401(k) plan withdrawal is subject to U.S. withholding tax at the rate of 30%.[7] If you're under age 59½, the withdrawal will also attract the additional 10% early withdrawal tax, for a total of 40%. When you withdraw the balance of your IRA or 401(k), the U.S. tax deferral ends. The only way to preserve the U.S. tax deferral is to transfer the funds from your current U.S. plan to another U.S. qualified plan.

The lump sum withdrawal out of your IRA or 401(k) plan will be subject to Canadian income tax in the year that you receive it. Since Canada should grant you a credit for the tax you paid to the United States, you should (as above) only pay the higher of the Canadian or the U.S. income tax, in aggregate.[8]

While the U.S. withholding tax may be treated as a final discharge under U.S. law, the Canada Revenue Agency (CRA) does not currently accept the U.S. withholding tax slip as adequate proof to grant you credit on your Canadian return for the U.S. tax paid. In practice, you should expect to file a U.S. income tax return and request a transcript[9] from the Internal Revenue Service (IRS), to provide to the CRA.

When you report your IRA or 401(k) withdrawal on a U.S. tax return, your U.S. tax liability is computed at the U.S. graduated tax rates. If this liability turns out to be lower than the tax that was withheld on the withdrawal, you'll recover the excess from the U.S. government.

If you wish to repatriate the funds but don't need them currently, the next section explores how you may preserve the tax deferral on a cross-border basis by contributing your IRA or 401(k) funds to a Canadian RRSP.

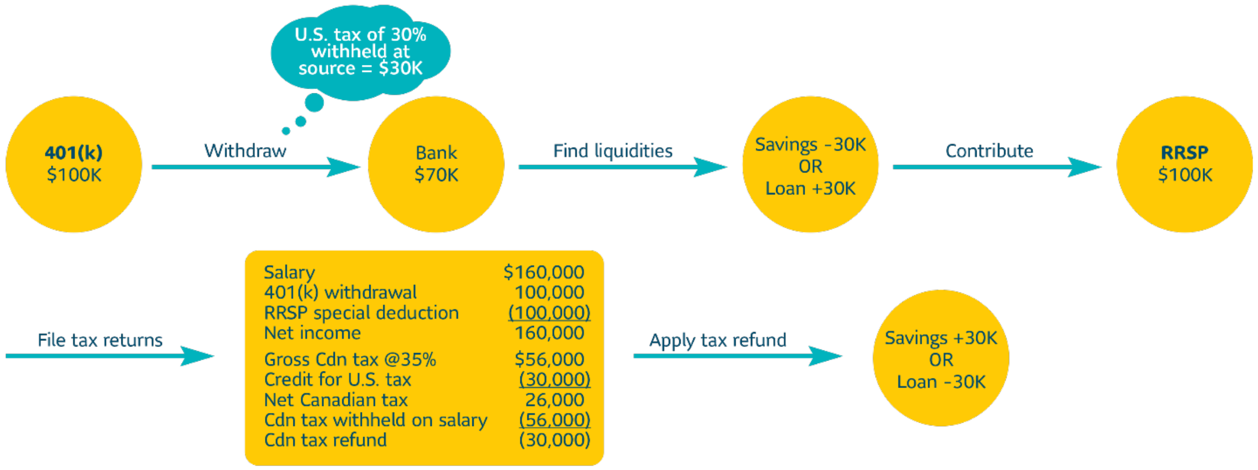
Repatriating the funds and contributing to a Canadian RRSP

With proper planning, IRA and 401(k) plan balances may be contributed to an RRSP[10] on a tax-neutral basis.[11] As outlined below, only lump sum withdrawals (not periodic payments) are eligible for this planning.

A withdrawal from an IRA or 401(k) plan creates a one-time, "special" RRSP contribution room.[12] This special room allows you to deduct from income an amount up to your IRA or 401(k) withdrawal amount in the year of withdrawal (and no other year). The Canadian income inclusion derived from the withdrawal is neutralized as a result.

Since the withdrawal is also subject to U.S. tax, the transfer will be tax-neutral only provided you can claim the U.S. tax paid as a credit against other sources of income on your Canadian tax return.

Let's illustrate how this works.[13] Assume you have CA$100,000[14] in a 401(k) plan and you are 60 years old. You earned salary of $160,000 from your Canadian employer and had no other sources of income this year.



Takeaways from this illustration include:

A. The tax-neutral effect of the transfer stems from your ability to recover the U.S. tax payable on your IRA or 401(k) withdrawal from the Canadian tax you paid (or should otherwise pay) on other sources of income (in this instance, salary). Absent other sources of income, or if your other income is insufficient to absorb the U.S. tax liability from the withdrawal by way of credit on your Canadian tax return, the transfer can't be accomplished on a tax-neutral basis. Note that any U.S. tax that you can't claim as a credit against your Canadian taxes in the year of withdrawal is a sunk cost since foreign taxes can't, in this context, be carried forward and claimed as a credit in future years. We recommend you consult your tax advisor to assess the optimal amount of IRA or 401(k) withdrawal and RRSP contribution that you can aim for given your particular circumstances. If your income tends to fluctuate from year to year, timing will be critical. As a rule-of-thumb, aim to have at least $1 of ordinary income for every $1 (converted to Canadian currency using the proper exchange rate) that you wish to repatriate from your IRA or 401(k) plan.

B. You;ll need to release liquidities from your existing investments or savings, or obtain a loan, to fund the U.S. withholding tax pending receipt of your Canadian tax refund (if applicable). This is because your RRSP special contribution must be made no later than 60 days following the year in which you withdraw your IRA or 401(k) balance, while your tax refund (if applicable) will come only after your tax return is filed and processed by the Canadian tax authorities. It's a timing issue, but it will likely require cash flow management on your part.

C. Upon filing a U.S. tax return, your tax liability is computed at the graduated rates of U.S. tax and Canada will grant you credit for that amount. The U.S. flat rate of 30% was used here as the final U.S. tax amount to keep the illustration simple.

D. While you may offset your Canadian income tax liability using a credit for U.S. tax paid, you may in turn be subject to alternative minimum tax. We recommend you discuss this with your tax advisor.

U.S. IRA and 401(k) plans offer several options, including the opportunity to repatriate the funds into a Canadian RRSP on a tax-neutral basis. Repatriation requires careful planning and execution. Please make sure to consult your tax advisor before you move the funds. If you decide to repatriate your U.S. retirement funds to Canada, your financial advisor can assist you in selecting investment assets that will accomplish your retirement objectives.

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[1] American citizens and green card holders are subject to U.S. tax on their worldwide income, irrespective of where they reside. This article discusses strategies for Canadian residents who do not qualify as U.S. taxpayers.

[2] It is important to distinguish traditional IRAs from Roth IRAs. A Roth IRA is like a Canadian Tax-Free Savings Account (TFSA). If the withdrawal rules are obeyed Roth IRA withdrawals are tax-free. This article focuses on traditional IRAs.

[3] 401(k) plans are only one type of qualified plan. This article focuses on 401(k) plans as well as IRAs, which are the most common.

[4] Pursuant to the Income Tax Convention between Canada and the United States.

[5] This credit is usually referred to as a "foreign tax credit".

[6] This assumes that your Canadian marginal rate of tax is higher than the 15% U.S. tax rate. In the event where this is not true for you, you would generally end up paying, in aggregate, the higher of the Canadian or the U.S. tax on the distributions.

[7] In practice, some plan administrators will apply a 15% rate, as though the withdrawal were a periodic distribution. For planning purposes, consider enquiring with your plan administrator which rate they intend to apply.

[8] See note 6 above.

[9] This document is the U.S. equivalent of a notice of assessment. You need to apply to receive it.

[10] The planning outlined in this section cannot take place with a Registered Retirement Income Fund (RRIF), thus it must be undertaken before the end of the year you turn age 71. Also, the transfer can only be made to a personal RRSP, not to a spousal RRSP.

[11] We use the term "tax-neutral" because tax consequences may be avoided with proper planning. The transaction is not, in and of itself, tax-free.

[12] Note that employer contributions to an IRA (where applicable) do not create special RRSP contribution room. This portion would require existing contributing room, or should be left out.

[13] The following illustration is an oversimplification of the rules and rates that apply in real life. It is solely intended to provide high-level guidance on the process and the economics at stake.

[14] Your account balance would likely be denominated in USD. To simplify the illustration, we assume that your USD balance is equal to CAD$100,000, when converted using the proper currency exchange rate.