STRATEGIES FOR CANADIANS WITH U.S. RETIREMENT PLANS

Canadian citizens who have lived and worked in the United States may own Individual Retirement Accounts (IRAs) and qualified retirement plans, such as 401(k) plans. When they return to Canada they may wonder what they should do with the money in these plans. Can they leave their money where it is? Can they move it to a Registered Retirement Savings Plan (RRSP)? What are the tax implications?

This article explores some of the options and tax considerations surrounding such questions, and discusses how to transfer traditional IRA[1] and 401(k) plan money to an RRSP.

CANADIAN RESIDENTS, AMERICAN CITIZENS AND GREEN CARD HOLDERS

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

FEATURES OF IRAS AND 401(K) PLANS

IRAs are similar to individual RRSPs. Generally, they are not 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 does not have the equivalent of a locked-in RRSP).
- By acquiring some or all of their spouse or common-law partner's IRA because of divorce or death of the spouse or common-law partner.

Like RRSPs, IRA balances grow tax deferred, and IRA withdrawals are taxed as income in the year withdrawn.

A 401(k) plan closely resembles a defined contribution pension plan.[4] Its name derives from the section of the Internal Revenue Code (IRC) that authorizes it. 401(k) plans are sponsored by employers who want to help their employees save for retirement through payroll deductions. 401(k) plans may include employer-matching contributions, though this is not required. Employers deduct

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[1] Throughout this article we will use the term "IRA" to refer to a traditional IRA, unless otherwise noted.

[2] A special type of qualified plan designed for small employers, a Simplified Employee Pension (SEP), uses employee-owned IRAs to which an employer makes contributions.

[3] The rules governing who may contribute to an IRA, how much they may contribute, and whether those contributions are deductible (and to what extent), are complex and beyond the scope of this article.

[4] 401(k) plans are only one type of qualified plan. There are different plans, such as 403(b) and 457(b) plans, but this article will discuss only IRAs and 401(k) plans unless otherwise noted.

their employees' contributions from income, and do not include their employer contributions in employees' income. Contributions grow tax deferred, just as they do in an IRA. There are limits to how much an employee and employer may contribute to a 401(k) plan. Though the limits are different from an IRA, generally (with minor differences that are beyond the scope of this article), 401(k) plans are subject to the same rules as IRAs.[5]

CONTINUING TAX DEFERRAL OF CANADIAN-OWNED U.S. PLANS

Under the Income Tax Act[6] and the Canada – United States Income Tax Convention Act (the Treaty)[7] Canadian residents may enjoy continued tax deferral of their IRA, 401(k) plan and Roth IRA[8] balances once they return to Canada, just as they would if they were still U.S. residents.[9] The deemed disposition and reacquisition rules under ITA section 128.1 do not apply to IRAs and qualified plans.[10]

Continuing tax deferral requires no action or election from a Canadian resident who owns an IRA, but an election must be filed for a Roth IRA (see discussion below). ITA clause 56(1)(a)(i)(C.1) exempts "foreign retirement arrangements" from tax "to the extent that the amount would not, if the taxpayer were resident in the country [i.e. the United States], be subject to income taxation in the country."[11]

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[5] Someone is a member of a 401(k) plan, but an owner of an IRA. For simplicity's sake, this article will use the term, "plan owner" to refer to those who own an IRA, and to those who are members of a 401(k) plan.

[6] Income Tax Act, R.S.C., 1985, c. 1 (5th Supp.), referred to herein as the ITA.

[7] S.C. 1984, c 20, implementing the Convention between Canada and the United States of America with Respect to taxes on Income and Capital.

[8] 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.

[9] Treaty, Article XVIII. Paragraph 81(1)(r) of the ITA governs tax deferral of IRAs owned by Canadian residents. 401(k) plans owned by Canadian residents are typically treated as "pension plans" and are therefore "employee benefit plans" under ITA subsection 248(1) (CRA Document 9410515, September 28, 1994). As long as an election to defer tax is filed, income is not recognized from U.S. pension plans until a withdrawal is taken. Note that in Jacques v. The Queen, 2016 TCC 245, the Court found that there was not enough evidence to establish that the 401(k) plan under consideration in that case was a "pension plan." This case is discussed in more detail later in this article.

[10] ITA subparagraphs 128.1(10)(a)(viii) and (x). These rules deem anyone who becomes a resident of Canada to have disposed of their property just before becoming a resident, and to have reacquired it at fair market value just after becoming a resident.

[11] ITA subsection 248(1) and Income Tax Regulation 6803 define a "foreign retirement arrangement" as a plan or arrangement to which §§408(a), (b) or (h) of the Internal Revenue Code (IRC) applies. Those IRC subsections describe

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

> *Where the accrued income in the plan is not taxable under the Act until it is paid out of the plan, there is no benefit to an individual in making the election [under the Treaty to defer tax]. In this regard, there would be no need to make the election for a traditional IRA because the Act already provides for a deferral of taxation for these plans. A traditional IRA is characterized as a foreign retirement arrangement for Canadian tax purposes. Under clause 56(1)(a)(i)(C.1) of the Act, an individual is required to include amounts under a foreign retirement arrangement in income only when the amounts are paid out of the plan.*[12]

Roth IRAs do not meet the definition of a "foreign retirement arrangement" under the ITA and Regulations. Therefore, Canadians who own Roth IRAs must file a one-time election to defer tax on their plan balances. The CRA does not provide a form for making the election, but does provide guidance describing the election's required elements for Roth IRAs:[13]

- Plan owner's name and address,
- Plan owner's social insurance number and social security number,
- Name and address of the Roth IRA trustee or plan administrator,
- Plan account number,
- Date that the plan was established,
- Date that the plan owner became a resident of Canada,
- Balance of the Roth IRA as of December 31, 2008 or as of the date on which the plan owner became a resident of Canada, whichever is later,
- Amount and date of the first Canadian contribution made to the Roth IRA, if any, and

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individual retirement accounts and individual retirement annuities (both referred to as IRAs), whether owned personally or in a custodial account.

[12] CRA Documents 2011-0404071E5 and 2015-0576551E5, June 25, 2012 and May 16, 2016. The CRA's guidance contained in its interpretation bulletins, responses to taxpayer inquiries and advance tax rulings is the CRA's interpretation of the law on a given subject and can help taxpayers plan their affairs in order to comply with the law. However, the CRA is not bound by what it says in its interpretation bulletins or by its responses to taxpayer inquiries. The CRA is bound by the ITA and Regulations, and by judicial decisions, all of which have the force of law. It is also bound by the Advance Tax Rulings (ATR) it issues, but only to the individual taxpayer who requested the ruling, and only as long as the circumstances outlined in the request for the ATR remain unchanged. The CRA is free to take a different position on a same or similar question or ruling request from a different taxpayer.

[13] Income Tax Folio S5-F3-C1, Taxation of a Roth IRA, available at https://www.canada.ca/en/revenue-agency/services/tax/technical-information/income-tax/income-tax-folios-index/series-5-international-residency/folio-3-cross-border-issues/income-tax-folio-s5-f3-c1-taxation-roth-ira.html.

- 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 a Canadian contribution is made.[14]

NONRESIDENT TAX TREATMENT OF A LUMP-SUM WITHDRAWAL FROM AN IRA OR 401(K) PLAN

IRA and 401(k) plan lump sum withdrawals are subject to a 30% U.S. withholding tax. The IRC imposes this rate on most amounts that a nonresident receives from sources within the United States.[15] In order to qualify for the reduced rate under the Treaty income must be periodic. Taxable amounts include items like interest, dividends, salaries and wages, plus a catch-all category – "other fixed or determinable annual or periodical gains, profits, and income" or FDAP. The IRS considers payments from "pensions and annuities" to be FDAP.[16] It has also confirmed that a lump sum withdrawal taken from a qualified plan by a Canadian citizen and resident would be treated as FDAP, and would be subject to the 30% tax rate.[17] It is reasonable to expect that the IRS would treat lump sum IRA withdrawals the same way.

To ensure that taxes imposed on nonresidents are paid, the IRC requires the financial institution disbursing funds to withhold 30% of the taxable amount, unless a tax treaty specifies a different rate.[18] Regarding pensions, the Treaty specifies a lower 15% withholding tax rate, but only for a "periodic pension payment".[19] Lump sum withdrawals and full surrenders are not periodic, so they do

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[14] Ibid, "1.14 A Canadian Contribution does not include a contribution made before 2009, or a rollover contribution from another Roth IRA or a Roth 401(k) arrangement. However, a rollover contribution (or conversion) from a traditional IRA, or from a qualified retirement plan (such as a traditional 401(k) or profit sharing plan), to a Roth IRA is a Canadian Contribution."

[15] IRC §871(a)(1)(A). See also IRS Document, "Characterization of Income of Nonresident Aliens," last reviewed or updated January 29, 2020, at https://www.irs.gov/individuals/international-taxpayers/characterization-of-income-of-nonresident-aliens. The rate is reduced if the provisions of an applicable tax treaty are satisfied.

[16] IRS Document, "Fixed, Determinable, Annual, Periodical (FDAP) Income," last reviewed or updated November 5, 2019, at https://www.irs.gov/individuals/international-taxpayers/fixed-determinable-annual-periodical-fdap-income.

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

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

[19] Treaty, Article XVIII.

not benefit from the lower 15% rate. To underscore this tax treatment, IRS Treasury Regulations specify that the manner in which FDAP is paid, lump sum or periodic, will not affect its tax treatment.[20]

If a plan owner resident in Canada could benefit from the Treaty's lower 15% withholding tax rate, for example by starting to take periodic payments from their IRA or 401(k) plan, they would first need to file IRS Form W-8BEN: "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding" with the plan administrator or IRA trustee, and would need to provide their Social Security Number (SSN) or Individual Taxpayer Identification Number (ITIN).[21] Plan owners who do not 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".[22]

While a plan owner could get the lower 15% Treaty withholding tax rate by taking periodic payments from their IRA or 401(k) plan, they would not be able to deposit those payments into their RRSP unless they had existing RRSP contribution room.[23] Taking periodic payments could therefore frustrate one of the strategies discussed later in this article – transferring money from an IRA or 401(k) plan to an RRSP on a tax-neutral basis.

10% PENALTY TAX

If the plan owner is under age 59½, an IRA or 401(k) plan withdrawal could attract a 10% premature withdrawal (or penalty) tax on the taxable amount under IRC §72(t). The 10% penalty tax would be in addition to any withholding tax imposed on the withdrawal. In most cases, the taxable amount for an IRA or 401(k) plan withdrawal will be the entire distribution. IRC §72(t) provides many exceptions to

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

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

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

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

the 10% penalty tax, but generally speaking, none of them apply to the type of lump sum withdrawal discussed in this article.[24] A plan owner who is under age 59½ and contemplating a withdrawal from their IRA or 401(k) plan should discuss the withdrawal with their independent tax advisor before taking distributions.

The financial institution disbursing funds to the plan owner will not withhold for the 10% penalty tax. Nor will the non-resident tax reporting slip the plan owner receives refer to the tax. However, the financial institution will provide a non-resident tax reporting slip that may refer to the fact that the distribution was made before the plan owner turned age 59½, and may note whether an exception to the 10% penalty tax applies. If the tax slip indicates that no exception applies, the IRS will be expecting payment of the penalty tax or a reason for why the tax does not apply.

If the plan owner is liable to pay the tax, they will have to calculate their liability by completing and filing IRS Form 5329: "Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts," together with a cheque for the appropriate amount of tax. If the plan owner has no other taxable transactions to report, the IRS will not require a non-resident tax return (IRS Form 1040NR). However, Form 1040NR and an IRS transcript will be required if the plan owner intends to claim a foreign tax credit on their Canadian tax return. If the plan owner is close to age 59½, they may want to consider postponing the withdrawal until after they have turned age 59½, to avoid the penalty tax.

CANADIAN TAX TREATMENT OF IRA AND 401(K) PLAN WITHDRAWALS

IRA and 401(k) plan withdrawals made by U.S. citizens or residents are taxed under U.S. law as income in the year of the withdrawal, even if growth in the plan has come from dividends or capital gains.

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[24] IRC §72(t) provides many exceptions from the 10% penalty tax for pre-age 59½ distributions. What follows is not a complete list. Among the exceptions are distributions

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

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.[25]

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 has sponsored the plan. The plan owner may withdraw such shares in kind, treating only the adjusted cost base in those shares as a taxable withdrawal. Any capital gain in the shares remains tax deferred until the plan owner sells the shares. At that time, any gain in the share price will be treated as a long-term capital gain, regardless of how long the shares were in fact held before sale.[26]

A Canadian 401(k) plan owner with employer shares in their plan should speak with their independent tax advisor before initiating a transfer of any 401(k) plan money to an IRA or RRSP. 401(k) plan administrators may transfer only money, not shares, and will have to sell the shares in order to make the requested transfer. It is not certain that a Canadian resident would be able to withdraw shares from their 401(k) plan in kind, and if so, whether they could treat only the adjusted cost base in those shares as taxable income for Canadian tax purposes, deferring tax on the capital gains until they sold the shares. However, if a Canadian resident were entitled, this favourable tax treatment would be lost if the 401(k) plan balance was transferred to an IRA or RRSP.

FOREIGN TAX CREDIT

The combination of U.S. non-resident withholding tax and Canadian income tax on the same IRA or 401(k) plan withdrawal creates a potential for double taxation. However, a Canadian plan owner

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

[26] 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.

should be able to claim a foreign tax credit on their Canadian income tax return to reduce or eliminate the double taxation that could result.[27]

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…."[28] (see Interpretation Bulletin IT-270R3, "Foreign Tax Credit," December 6, 2018.) A Canadian plan owner may not claim a foreign tax credit for items like surrender charges and administrative fees that the institution holding the plan owner's IRA or 401(k) plan imposed on the transfer, only taxes.

The term, "foreign … taxes paid" refers only to the foreign taxes the Canadian plan owner was legally obligated to pay,[29] as shown on the foreign country's equivalent of a Notice of Assessment. In the United States, that document is called a transcript. While the CRA provides a Notice of Assessment automatically after a taxpayer has filed their tax return, the IRS provides a transcript only on request.

As noted above, if a taxpayer withdraws money in a lump sum from their IRA or 401(k) plan, the institution holding the IRA, or the plan administrator for the 401(k) plan, will withhold 30% of the withdrawal for the IRS. If the taxpayer is under age 59½, and no exception applies, the taxpayer will also have to calculate their 10% penalty tax, and report it on IRS Form 5329. As noted above, the Form 5329 can be sent to the IRS on its own if there is no further tax liability (or no claim for a refund), or it can be attached to a Form 1040NR (non-resident tax return).

The taxpayer can file a form 1040NR with the IRS if they believe that the 30% tax withheld was too high. On the form, the taxpayer reports all their U.S. reportable income, and calculates their tax liability using graduated rates. If the taxpayer is a Canadian resident, and not a U.S. citizen or green card holder, and if the IRA or 401(k) plan withdrawal was their only U.S. income, that is all the income they will have to report. They will not have to report any of their other income (Canadian or from other countries) to the IRS.

[27] 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.

[28] Interpretation Bulletin IT-506, "Income Taxes as a Deduction From Income", January 1, 1995 at paragraph 1. An archived version is available at https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/it506/archived-foreign-income-taxes-a-deduction-income.html.

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

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

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

We will make the following assumptions for this example:[31]

- The plan owner lives in Ontario.
- 2021 U.S. and Canadian tax rates apply.
- The IRA withdrawal is the plan owner's only taxable U.S. transaction for the year.
- The U.S. financial institution deducts only withholding tax; it deducts nothing for items like surrender charges.
- The Canadian and U.S. dollars are at par.[32]
- The plan owner earns $150,000 in income in addition to their IRA withdrawal.
- The plan owner contributes the $100,000 withdrawal to their RRSP. As we discuss later, the $100,000 IRA withdrawal creates additional RRSP contribution room in the same amount as the withdrawal. Most plan owners will have to contribute the withdrawal by the normal RRSP contribution deadline – 60 days after the end of the tax year – or lose the right to make the contribution. Plan owners who turn age 71 during the year must make the contribution by the end of the year, and must leave enough time before the end of the year to convert their RRSP to a Registered Retirement Income Fund (RRIF) before year end.
- The plan owner also qualifies for federal and provincial tax credits in respect of the basic personal amount, and for a federal tax credit in respect of the Canada employment amount.

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

[31] The example is for illustration purposes only, to help clarify the foreign tax credit concept, and should not be relied on by anyone in any transaction.

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

In this example, a $100,000 IRA withdrawal will attract total U.S. tax of $18,021, $11,979 less than the 30% withholding tax.[33] We have assumed the taxpayer's marital status is single. In the United States, the tax rates and tax brackets applicable to someone filing as a single person are different from those who are married and file as "married filing jointly". However, the IRS will not allow non-resident married individuals to file as married filing jointly, only as single.

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

The tax calculation to determine the foreign tax credit requires that the taxpayer calculate their income after deductions (like RRSP contributions) but before applying any tax credits (like the basic personal amount or the Canada employment amount).

After deducting the RRSP contribution, the plan owner's Canadian federal tax liability on $150,000 will be approximately $28,652, and their provincial tax liability will be approximately $12,525 ($41,177 in total). The federal foreign tax credit is calculated as the plan owner's foreign income amount divided by their total adjusted Canadian income, multiplied by the federal tax owing on that income. In this case, the tentative federal foreign tax credit works out to $19,101 ($100,000 divided by $150,000 times $28,652), but is reduced to a final amount of $18,021, the actual amount of foreign tax paid.

Since the federal foreign tax credit was enough to cover the U.S. tax liability, there's no need to calculate the provincial foreign tax credit. However, that may not always be the case. For example, if the plan owner was under age 59½ when they took the withdrawal there would be an additional 10% penalty tax, bringing the total U.S. tax bill to $28,021, $8,920 over the federal foreign tax credit amount.

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[33] IRS provides tax inflation adjustments for tax year 2021: https://www.irs.gov/newsroom/irs-provides-tax-inflation-adjustments-for-tax-year-2021#:~:text=Marginal%20Rates%3A%20For%20tax%20year,married%20couples%20filing%20jointly)%3B.

CRA guidance allows taxpayers to use the foreign tax credit to offset foreign income tax, and considers the U.S. 10% penalty tax to be a tax on income.[34] We therefore calculate the provincial foreign tax credit, still using Ontario as the province of residence.[35]

The provincial foreign tax credit is calculated the same as the federal tax credit: $100,000 divided by $150,000 times $12,525, or $8,350. When we combine the federal and provincial foreign tax credits, we get a final foreign tax credit of $27,451, $570 less than the amount needed to cover the remaining U.S. tax liability.

There may be other reasons for why the foreign tax credit may not always be enough to completely offset a plan owner's U.S. tax liability. The taxpayer's Canadian income may be too low or the IRA or 401(k) plan withdrawal too large. Therefore, before withdrawing any money from their IRA or 401(k) plan, a plan owner, working with their independent tax advisor, will need to estimate their tax bill for the year, to determine how much they can withdraw from their IRA or qualified plan, and still get a foreign tax credit that completely covers their U.S. tax obligation.

If a plan owner determines that they will not be able to offset the entire U.S. tax obligation for a given withdrawal, they may be able to spread the withdrawal over two or more years, assuming they have enough time before the year they turn age 72 to make all the withdrawals they wish to make. They must also take care to make sure that their withdrawals do not resemble periodic payments, and must ensure that they have discussed this aspect of the strategy thoroughly with their independent tax advisor. The CRA has stated that whether a payment is part of a series of periodic payments is a question of fact. In general, though, the CRA considers a series of periodic payments to comprise at least three equal or similar payments made at regular intervals.[36]

The CRA has dealt with a potential problem from using the foreign tax credit – that it can be used only to reduce tax on the same income. When the plan owner contributes the IRA or 401(k) plan withdrawal to their RRSP, the deduction eliminates the Canadian tax owing on the withdrawal.

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

[35] Ontario provincial tax rates for 2021 found at Canada Revenue Agency, Canadian income tax rates for individuals - current and previous years: https://www.canada.ca/en/revenue-agency/services/tax/individuals/frequently-asked-questions-individuals/canadian-income-tax-rates-individuals-current-previous-years.html#provincial.

[36] CRA Document No. 2013-0493691C6 (F), October 11, 2013.

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".[37] As a result, a foreign tax credit could still be available to partly or fully offset U.S. withholding tax arising from the withdrawal.

Foreign tax credits applicable to non-business foreign income (like IRA and 401(k) plan withdrawals) may not be carried forward to future years. If the plan owner cannot use them in the year of the withdrawal, they are lost. Only foreign tax credits applicable to foreign business income may be carried forward for use in future years.[38]

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

REQUIRED MINIMUM DISTRIBUTIONS DURING THE PLAN OWNER'S LIFE

As mentioned above, if a plan owner decides not to transfer their IRA or 401(k) plan balances to an RRSP, they can still maintain their plan balances tax deferred. However, tax deferral does not last forever, on either side of the border.

The U.S. SECURE Act,[39] signed into law on December 20, 2019, and in force as of January 1, 2020, made several changes to the IRA and qualified plan rules. In particular, the SECURE Act modified the required minimum distribution (RMD) rules for plan owners and their beneficiaries. RMDs are similar to minimum formula distributions in Canada. The RMD rules govern the minimum amounts that plan owners must take from their IRAs and qualified plans during their lifetimes, and the minimum amounts that their beneficiaries must take from those plans after the plan owner has died.

One change extends the date by which RMDs must begin: to the end of the year the plan owner turns age 72 (changed from the end of the year the plan owner turns age 70½). This change applies only to those who attain age 70½ after December 31, 2019.[40] Plan owners who turned age 70½

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[37] CRA Document 9634955, March 5, 1997.

[38] ITA section 126.

[39] The Setting Every Community Up For Retirement Enhancement (SECURE) Act of 2019.

[40] SECURE Act, §114(d).

before January 1, 2020 must continue taking RMDs according to the old rules. They may not stop RMDs and begin again by the end of the year they turn age 72.

Unlike Canadian minimum formula distributions, there is 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) from their IRA or qualified plan by December 31st of the year they turn age 72, and by December 31st of each year after that.

RIGHT TO DELAY FIRST RMD

A plan owner may delay taking their first RMD until April 1st of the year after they turn age 72. However, if the plan owner decides to delay taking the first RMD, they will still have to take a separate RMD by December 31st of year 2, resulting in them taking (and paying tax on) two RMDs in year 2.

ANNUITIZING THE IRA OR PLAN BALANCE

Some plan owners desire the security of a guaranteed lifetime stream of income for part or all of their retirement income needs. The U.S. and Canadian rules let them convert all or part of their IRA or qualified plan balances into life annuities, with or without term certain guarantees and beneficiaries. The life annuity income will satisfy the RMD rules without the need to calculate an RMD every year.

For plan owners who do not want to annuitize their plans, the RMD rules govern when and how they must take distributions from those plans.

CALCULATING RMDS – UNIFORM LIFETIME TABLE (ULT)

During the plan owner's lifetime, RMDs are calculated using one of two tables published by the IRS – the Uniform Lifetime Table (ULT) or the Joint and Last Survivor table (JLST). The ULT is the table most commonly used. It bases RMDs on the life expectancies of the plan owner and an imaginary beneficiary 10 years younger. The table uses an imaginary beneficiary to stretch distributions over a period longer than the plan owner's actual life expectancy. This results in lower minimum distributions than if only the plan owner's actual 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 in its life expectancy calculation, there is no requirement for a plan owner using the ULT to name a beneficiary to their plan, or, if they do, that the beneficiary be a specific age.

CALCULATING RMDS – JOINT AND LAST SURVIVOR TABLE (JLST)

A less commonly used table, the 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 may be used, but those circumstances result in lower RMDs than the ULT produces for the same plan owner, and potentially longer distribution periods.

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

- The age that the plan owner will attain by December 31st of the current year,
- The plan's account balance on December 31st of the previous year, and
- The actuarial present value (APV) of the account's future benefits.[41]

ACTUARIAL PRESENT VALUE OF FUTURE BENEFITS

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

[41] IRC §401(a)(9). Also see "IRS Publication 590-B, Distributions from Individual Retirement Arrangements (IRAs)", available at https://www.irs.gov/pub/irs-pdf/p590b.pdf.

applies to the guarantee. If it does, the institution calculates the APV of the guarantee and advises the plan owner. The plan owner then adds the value of the guarantee to the account value and calculates their RMD accordingly.

CONSEQUENCES FOR FAILING TO TAKE AN RMD ON TIME

The consequences for failing to take an RMD on time are severe – a penalty tax equal to 50% of the RMD the plan owner should have taken. In addition, the plan owner will still have to take the RMD and pay income tax on it, plus interest on the tax that they should have paid for the year they should have taken the RMD. Unlike the case with RRIFs, U.S. law does not require the plan owner's financial institution to pay the RMD by the end of the year if the plan owner has not already taken it. Nor is there any requirement for a financial institution to pay any part of the IRA or 401(k) plan balance to the plan owner by the end of the year if the plan owner has failed to take sufficient distributions by the end of the 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.[42] However, the CRA has since decided that the 10% penalty tax is an income tax and that a plan owner may use a foreign tax credit to completely or partly offset it.[43]

Since the 50% tax is also a penalty tax, the same reasoning may apply to allow a plan owner to use a foreign tax credit to completely or partly offset the impact of that tax as well. The better approach, though, is for a plan owner to consult with their independent tax advisor to make sure that they take RMDs on time and avoid the 50% penalty tax entirely.

DEATH OF AN IRA OWNER OR 401(K) PLAN OWNER

ESTATE TAX

When an IRA or 401(k) plan owner dies, the value of the IRA or 401(k) plan going to their beneficiaries is included in their taxable estate. If the plan had been annuitized (i.e. converted from

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[42] CRA Documents 9304595 and 9330140, May 19, 1993 and November 15, 1993.

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

assets into a stream of income) the present value of any future payments for the beneficiary is included in the deceased's estate. If the plan had remained in the form of assets, the value of those assets on the date of death would be included in the deceased's estate.[44]

A non-citizen/non-resident is subject to estate tax only on their "U.S. situs assets," which includes IRAs and 401(k) plans. If the value of the deceased's "U.S. situs assets" exceeds US$60,000 at the date of death, the plan owner's executor will have to file a U.S. estate tax return (IRS Form 706NA[45]) with the IRS within 9 months of death, reporting the deceased's "U.S. situs assets" and their values at death.[46] If the value of the deceased's U.S. situs assets was less than US$60,000 at death, there will be no need to file an estate tax return. The executor may wish to file one anyway, though, as some financial institutions will want IRS confirmation that there is no estate tax owing before they transfer assets to the estate or beneficiaries.

If the date of death value of the deceased's U.S. situs assets exceeds US$60,000, the executor may reduce or eliminate estate tax by using a tax credit (called the unified credit). For American citizens and residents, the unified credit lets an individual during life, or an estate at death, pass up to US$11.7 million free from estate and gift tax (2021 limit, adjusted annually for inflation). This US$11.7 million amount is also referred to as the "exemption equivalent", and is set to be cut in half (again, adjusted for inflation) on January 1, 2026, unless Congress changes the law before then.

For example, if inflation would have caused the exemption equivalent to grow to US$12 million by January 1, 2026, it will instead be $6 million for that year, adjusted for inflation for each year thereafter.

Under the Treaty, Canadian estates benefit from the unified credit in the same proportion that the deceased's U.S. situs assets bear to their worldwide estate.[47]

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[44] An estate may also value assets at the alternate valuation date – the date that is 6 months after the date of death. The election must cover all estate assets, though, not just select assets. We assume in this article that the alternate valuation date is not elected.

[45] https://www.irs.gov/pub/irs-pdf/f706na.pdf.

[46] See our bulletin, "U.S. Taxes for Canadians with U.S. Assets", available at: https://www.sunnet.sunlife.com/files/advisor/english/PDF/US_Estate_and_Gift_Taxes_for_Canadians_bulletin.pdf.

[47] The world-wide estate is determined using U.S. estate tax rules. This can produce surprising results for Canadians who are not familiar with those rules. For example, the death benefit from a life insurance policy the deceased owned on their own life, and the present value of any annuity and pension income benefits going to a beneficiary are included as assets in the deceased's world-wide estate.

For example, if 10% of a Canadian plan owner's worldwide estate was comprised of U.S. situs assets, their estate could use 10% of the unified credit. Under current rules, they could pass up to US$1,170,000 in U.S. situs assets free from estate tax. Because of this Treaty provision, a Canadian estate would only pay U.S. estate tax once the worldwide value of the estate exceeded the U.S. exemption equivalent amount (US$11.7 million for 2021, indexed for inflation).

U.S. INCOME TAX

Considering only U.S. income tax for the moment, whether the beneficiary receives a continuing stream of annuity income, or distributions from the deceased's plan, they must treat whatever they receive as income for the year they receive it. Since the same money is being taxed under the estate and income tax regimes, there is a potential for double taxation at the U.S. federal level.

The IRC addresses this double taxation issue by letting the beneficiary deduct from their income tax the amount of estate tax attributable to the inclusion of the IRA and 401(k) plan balance in the deceased's estate.[48]

Canadian residents receiving pension payments from a deceased plan owner's U.S. pension may also deduct U.S. estate taxes attributable to any U.S. pension plan income they receive, also to avoid double taxation.[49] In its guidance, the CRA considered a U.S. pension plan, but the CRA's reasoning could also apply to an IRA or 401(k) plan. A plan owner should check with their independent tax advisor about this potentially valuable tax treatment.

CANADIAN INCOME TAX

If a Canadian IRA or 401(k) plan owner had annuitized their plan, any plan income in the beneficiary's hands will be taxed as income to the beneficiary in the year received. For plans that were not annuitized, the Canadian tax treatment is the same for IRAs and 401(k) plans, but for different reasons.

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[48] To determine the deductible amount the executor creates two estate tax returns, one that includes the IRA and/or 401(k) plan, and one that does not. The difference in estate tax between the two is the amount that is available for the beneficiary to use as a deduction.

[49] CRA Document 2009-0313171E5, 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.

Depending on the terms of the plan, an IRA plan balance may be treated as a "right or thing" at the IRA owner's death. A right or thing is income to which the deceased was entitled at death, but in fact never received. The following are examples of rights or things:

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

Under Canadian tax law, the executor of a deceased IRA owner has three choices for dealing with the money in the IRA:[50]

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

To take advantage of the tax deferral opportunities offered under the RMD rules, the executor would treat the IRA as a "right or thing" and choose the third option. Additionally, the third option is the only option that will allow the taxpayer to claim a foreign tax credit.

401(k) plans that have not been annuitized will receive the same Canadian tax treatment, 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.[51] As with an IRA, the beneficiary may use a foreign tax credit to offset some or all of the U.S. withholding tax.

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

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

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

The payments will also be taxable for Canadian tax purposes for the year received, and will be subject to the U.S. 15% non-resident withholding tax under the Treaty.[52]

As will be discussed below, for most non-spouse beneficiaries current tax deferral opportunities are more limited than they were before the SECURE Act was passed.

RMDS AT THE PLAN OWNER'S DEATH – NEW RULES UNDER THE SECURE ACT

Under the SECURE Act unless the beneficiary is an "eligible designated beneficiary" (described below), a deceased plan owner's entire plan balance must be distributed by the end of the year containing the 10th anniversary of death. It will not matter whether the plan owner died before or after they had started taking distributions from their plan. In any given year the beneficiary may take as little or as much as they want, as long as they have taken the entire plan balance by the end of the year containing the 10th anniversary of the plan owner's death.

The following "eligible designated beneficiaries" have additional distribution options, and do not have to follow the 10-year rule (though they may if they want to):

- A surviving spouse,
- A disabled individual within the meaning of IRC §72(m)(7),
- A chronically ill individual within the meaning of IRC §7702B(c)(2), subject to one modification under the SECURE Act,
- An individual who is younger than the deceased IRA or plan owner by 10 years or less, and
- A minor child (though the 10-year rule begins to apply once the minor reaches the age of majority, unless the child is disabled or chronically ill)

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[52] Interpretation Bulletin, IT-499R, "Superannuation or Pension Benefits," January 17, 1992, paragraph 9. An archived version is available at https://www.canada.ca/content/dam/cra-arc/formspubs/pub/it499r/it499r-e.pdf. CRA Document 9800545, August 10, 1998 in part discusses the tax treatment of amounts received from an IRA that has been annuitized. CRA Document 2000-0040385, October 17, 2000 in part discusses the tax treatment of amounts received from a pension plan that has been annuitized.

Regarding a "disabled individual", under IRC §72(m)(7) an individual is disabled when they are "unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration," and can provide proof of their disability.

Under IRC §7702B(c)(2) a "chronically ill individual" is someone who has been certified within the previous 12 months by a licensed health care practitioner (a physician, registered professional nurse, licensed social worker or other individual who meets the regulatory requirements) as

- being unable to perform (without substantial assistance from another individual) at least 2 activities of daily living for a period of at least 90 days due to a loss of functional capacity,
- having a level of disability similar (as determined under regulations prescribed by the Secretary [of the Treasury] in consultation with the Secretary of Health and Human Services) to the level of disability described in clause (i), or
- requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment.

The modification referred to in the third bullet point above is that if a person is unable to perform at least 2 activities of daily living, the certification must also state that their condition is an indefinite one that is reasonably expected to be lengthy in nature.

The activities of daily living are:

- Eating
- Toileting
- Transferring
- Bathing
- Dressing
- Continence

RMDS AT THE PLAN OWNER'S DEATH – OLD RULES

The old RMD rules remain in effect for beneficiaries of plan owners who died before January 1, 2020 and for eligible designated beneficiaries. Under the old rules, spousal and non-spousal beneficiaries were treated differently.

DEATH BEFORE RBD – NON-SPOUSE ELIGIBLE DESIGNATED 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 does not exceed the beneficiary's remaining life expectancy (as measured by the RMD Single Life Expectancy Table (SLET)) for the year annuity payments begin. If a lifetime payout with guarantee period is selected, the guarantee period cannot exceed the beneficiary's remaining life expectancy using the RMD SLET for the year annuity payments begin.
- Five-year distributions: Take as little or as much as desired in any year (even nothing), as long as the entire IRA or 401(k) plan balance is distributed by December 31st of the year containing the fifth anniversary of the plan owner's death.
- Life expectancy distributions: Stretch distributions over the beneficiary's life expectancy using the RMD SLET, starting in the year after the plan owner's death, and subtracting one from life expectancy every year.[53] Distributions continue until the end of the beneficiary's life expectancy, whether the beneficiary lives beyond that date or dies before it.

DEATH ON OR AFTER RBD – NON-SPOUSE ELIGIBLE DESIGNATED 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 does not exceed the beneficiary's life expectancy. If a lifetime payout with guarantee period is selected, the guarantee period cannot exceed the beneficiary's remaining life expectancy using the RMD SLET for the year annuity payments begin.
- Life expectancy distributions: Stretch distributions over the longer of:
    - The plan owner's remaining life expectancy as of their date of death (using the RMD SLET), and subtracting one from life expectancy every year. Distributions continue until the end of the plan owner's life expectancy, whether the beneficiary lives beyond that date or dies before it, or

[53] 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.

- The beneficiary's own life expectancy (using the RMD SLET), starting in the year after the plan owner's death, and subtracting one from life expectancy every year. Distributions continue until the end of the beneficiary's life expectancy, whether the beneficiary lives beyond that date or dies before it.

DEATH BEFORE RBD – SPOUSE IS THE SOLE BENEFICIARY

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

DEATH ON OR AFTER RBD – SPOUSE IS THE SOLE BENEFICIARY

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

DISTRIBUTION OPTIONS THAT DO NOT DEPEND ON WHEN THE PLAN OWNER DIES – SPOUSE IS SOLE BENEFICIARY

In addition to the two distribution options noted above, the surviving spouse may:

- Take an immediate lump sum distribution.
- Take lifetime distributions: Annuitize the IRA or 401(k) plan balance over the surviving spouse's life, with or without a guarantee period, or over a term certain period that does not exceed the surviving spouse's remaining life expectancy as measured by the RMD SLET for the year annuity payments begin. If a lifetime payout with guarantee period is selected, the guarantee period cannot exceed the surviving spouse's remaining life expectancy as measured by the RMD SLET for the year annuity payments begin.
- Assume ownership of the deceased plan owner's IRA or 401(k) plan by:
    - Telling the financial institution that they will 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 spouse's IRA. Since only an owner may contribute to an IRA, the spouse will be deemed to have assumed ownership of the IRA by making a contribution to it.

No matter the method chosen to assume ownership of the deceased plan owner's IRA or 401(k) plan, the surviving spouse will own the IRA or 401(k) plan as if they had originally contributed to it. Accordingly, the contribution and distribution rules that applied to the deceased spouse will now apply to the surviving spouse. For example, under the old rules, upon assuming ownership of the deceased spouse's IRA or 401(k) plan, the surviving spouse would not be required to take RMDs until April 1st of the year following the year they attained age 70½, and would 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 would have to start taking RMDs beginning in the year after the plan owner's death. Under the SECURE Act, the age 70½ threshold is changed to age 72.

The RMD rules contain some other details:

- Only amounts distributed during the year are treated as income. Balances that have not yet been distributed remain tax deferred.
- 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. The IRS has shown some leniency on this rule, in that it has allowed beneficiaries to convert to life expectancy distributions within the (pre-SECURE Act) five-year rule period. The discretion to allow a conversion could be exercised even if some RMDs have been missed.[54] Although a 50% penalty tax applies to missed RMDs, a taxpayer can ask the IRS to exercise its discretion to waive the penalty tax if reasonable grounds for waiving the penalty exist.
- If a beneficiary takes more than their RMD in any given year, no credit is allowed to reduce the beneficiary's future RMDs

54 IRS Private Letter Ruling 200811028, December 21, 2007. This ruling involved an "inherited IRA." An inherited IRA is an IRA owned by the IRA beneficiary, and which receives the deceased plan owner's IRA funds. An inherited IRA is subject to the distribution rules applicable to the IRA beneficiary.

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, do not 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. However, when the surviving spouse dies, the plan administrator will send a cheque to whoever is named as the non-spouse beneficiary(s). The plan will not offer any distribution options that would permit greater tax deferral. A plan owner who wants to preserve tax deferral on 401(k) plan balances for their children, and who wants to keep the money in the United States, should confirm with the plan administrator that the appropriate distribution options are available, or consider transferring their 401(k) plan balance to an IRA.

OPTIONS FOR CANADIANS OWNING IRAS OR 401(K) PLANS

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

1. Withdraw the money in a lump sum

If the plan owner withdraws their IRA or 401(k) plan money after returning to Canada, they will have to include the entire withdrawal in income for Canadian tax purposes. The withdrawal also will be subject to a 30% U.S. non-resident withholding tax. It may be possible to offset some or all of this tax with a foreign tax credit. See the discussion above for details on the process for claiming a foreign tax credit.

However, if the Canadian citizen withdraws the money while still a United States resident, the withdrawal will be subject to U.S. income tax rates that could be lower than Canada's and the U.S. non-resident withholding tax rate.[55] Bear in mind that the tax outcome depends to a certain extent on the plan owner's state (and possibly city) of residence before returning to Canada.

[55] 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.

Some U.S. states do not charge personal income tax.[56] The tax result could also depend on whether the plan owner is returning early or late in the year. Before making a withdrawal, a plan owner should discuss the potential tax outcome with their independent tax advisor.

Withdrawing money from an IRA or 401(k) plan may not be appropriate for younger plan owners, even if the plan owner could complete the transaction while still a U.S. resident. The loss of continued tax deferral plus ongoing taxation of investment growth at Canadian tax rates may offset any tax savings the plan owner may realize from withdrawing IRA or 401(k) plan money while still subject to the U.S. tax system.

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

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

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

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

This is a popular choice with U.S. citizens and residents when they leave an employer. IRAs offer continued tax-deferred growth potential, consolidation of assets into one account to reduce paperwork, and flexible withdrawal and beneficiary options. Most IRAs also offer more investment choices than a 401(k) plan, and access to more personalized investment advice. Moving money to an IRA can also be a good choice for plan owners who anticipate one day returning to the United States.

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

The CRA regards a 401(k) plan-to-IRA transfer as tax-free after the plan owner has returned to Canada to become a Canadian resident.[57]

However, this transfer may cause problems for Canadian residents due to 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 firms allow it while others do not, though the weight of opinion appears to be shifting towards not allowing it. The confusion arises because different institutions interpret U.S. securities laws differently.

It is 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 does not 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 does not.

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 TFSAs. Under U.S. tax law, contributions to a Roth IRA are not 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.[58] There is 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

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[57] CRA Document No. 2011-0407461E5, June 19, 2012.

[58] IRS Publications 590a and 590b, "Contributions to Individual Retirement Arrangements (IRAs)," and "Distributions from Individual Retirement Arrangements (IRAs), available at https://www.irs.gov/pub/irs-pdf/p590a.pdf and https://www.irs.gov/pub/irs-pdf/p590b.pdf.

those amounts into income for the year of the conversion. Once converted, and as long as the Roth IRA rules are respected, there should never be any tax on the contributions or growth in the Roth IRA.

There are no required distributions from a Roth IRA for the plan owner or spouse beneficiary at the plan owner's death. However, a non-spouse beneficiary will have to withdraw money each year from the Roth IRA using the RMD rules discussed above, as modified by the SECURE Act. There is no income tax on the amounts withdrawn, but there is 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 are not deductible, but plan assets grow tax-free. Withdrawals are not taxed, provided again that the plan owner is over age 59½, and at least five years have passed from the tax year for which the original designated Roth account contribution was made. 401(k) plan contributing room remains the same whether contributions go to the designated Roth account or to the pre-tax deferral account.[59] While an employer may match contributions an employee makes to their designated Roth account, the employer's contributions may not go to a Roth account; they must go into a pre-tax account.[60]

A 401(k) plan owner may transfer any amount from their plan's pre-tax deferral account to their plan's designated Roth account.[61] 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.

[59] $19,500 in 2021 plus $6,500 for employees age 50 and over: https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-401k-and-profit-sharing-plan-contribution-limits#:~:text=Deferral%20limits%20for%20a%20SIMPLE,cost%2Dof%2Dliving%20PDF%20adjustments. IRA contribution room is limited to $6,000, $7,000 for those aged 50 and older: https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-ira-contribution-limits.

[60] See IRS guidance at https://www.irs.gov/retirement-plans/retirement-plans-faqs-on-designated-roth-accounts#8designated, last updated March 11, 2021.

[61] 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.

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.[62]

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 1st of the year following the year the plan owner turns age 72, 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 do not apply to 401(k) plans, whether the plan contains pre-tax deferrals or designated Roth accounts.

IMPACT OF THE TREATY ON ROTH IRAS AND DESIGNATED ROTH ACCOUNTS

Under the latest amendments to the Treaty, Canada respects the tax deferral that both Roth options offer, provided the individual made their contributions while a United States resident, and elects to continue tax deferral once in Canada. Roth IRA and designated Roth account withdrawals that would not be taxed in the United States will not be taxed in Canada provided the election noted above has been made.

Any Roth IRA conversion or 401(k) plan rollover to a designated Roth account should be done before the plan owner returns to Canada. If the plan owner waits until after becoming a Canadian resident, the conversion amount is included in income under Canadian law.[63] Further, the Treaty does not protect Roth IRA balances that result from a conversion done after 2008 while the individual is a Canadian resident.[64] The growth on those balances will be taxed each year.

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[62] 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 do not 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 plan 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 cannot be re-contributed, so that the money and the tax-deferred or tax-free growth on that money will not be available in retirement.

[63] ITA subsection 56(12).

[64] Ibid, note 11, Income Tax Technical News No. 43, p. 2, available at https://www.canada.ca/content/dam/cra-arc/formspubs/pub/itnews-43/itnews-43-e.pdf.

Accordingly, if a Canadian citizen living in the United States knows in advance that they will return to Canada, they may wish to do a Roth IRA conversion before leaving the United States, or move money from the pre-tax deferral account in their 401(k) plan to their plan's designated Roth account.

In addition to benefitting from the Treaty's protection of the Roth balances from ever being taxed, they may also benefit from paying tax on the conversion at lower U.S. tax rates. Currently, the Treaty does not allow transfers of Roth IRA or designated Roth account balances to a TFSA, or vice versa. Roth IRA conversions and designated Roth account rollovers are complicated, and require the assistance of an independent tax advisor.

4. Leave the balance with the former employer's 401(k) plan

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

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

Advantages

- **For distributions taken in 2021,** IRA and 401(k) plan RMDs are lower than RRIF minimum formula distributions for plan owners age 72 and over.[65]

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

[65] 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 https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/ic78-18.html. RMDs are calculated using the age the plan owner will attain during the distribution year. See IRS Publications 590a and 590b, "Contributions to Individual Retirement Arrangements (IRAs)," and "Distributions from Individual Retirement Arrangements (IRAs), available at https://www.irs.gov/pub/irs-pdf/p590a.pdf and https://www.irs.gov/pub/irs-pdf/p590b.pdf. The percentage distributions for RRIFs and RMDs have been adjusted so that they use the same ages for each distribution year.

- **For distributions starting in 2022 and going forward**, IRA and 401(k) plan RMDs are even lower than RRIF minimum formula distributions for plan owners age 72 and over.[66]

Plan owner's age	RRIF minimum	RMD withdrawal
72	5.28%	3.65%
82	7.08%	5.41%
89	10.21%	7.75%

- **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 72 through a failure to act in time.
- **15% treaty withholding tax rate on periodic pension and annuity payments**. With the low Treaty withholding tax rate, it may be possible to use the foreign tax credit to fully or partly offset the Treaty withholding tax on IRA and 401(k) plan withdrawals.
- **Tax deferral may continue after the plan owner's death**. At the plan owner's death U.S. law allows a tax-free rollover of the plan balance to the surviving spouse and/or a non-spouse eligible designated beneficiary. Some 401(k) plan administrators do not offer tax deferral to non-spouse beneficiaries. It is important to check with the plan administrator.

  Canada's foreign asset reporting requirement. IRAs and 401(k) plans are exempt from Canada's foreign asset reporting requirement. Roth IRAs are exempt if the plan owner has filed the Roth IRA election referred to earlier in this article. Canadian residents must disclose to the CRA any ownership interest they have in "specified foreign property" if the cumulative value of that property exceeds C$100,000. "Specified foreign property" is defined to not include an interest in an "exempt trust."[67] An "exempt trust" is a "trust that is governed by a foreign retirement arrangement" (such as 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).[68] The CRA has also said that it considers Roth IRAs to be "specified foreign property", so Canada's foreign asset reporting rules apply to Roth IRAs unless

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[66] 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 https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/ic78-18.html. RMDs are calculated using the age the plan owner will attain during the distribution year. See IRS Publications 590a and 590b, "Contributions to Individual Retirement Arrangements (IRAs)," and "Distributions from Individual Retirement Arrangements (IRAs), available at https://www.irs.gov/pub/irs-pdf/p590a.pdf and https://www.irs.gov/pub/irs-pdf/p590b.pdf. The percentage distributions for RRIFs and RMDs have been adjusted so that they use the same ages for each distribution year.

[67] ITA subsection 233.3(1) (see paragraph (n) of the definition of "specified foreign property").

[68] ITA subsection 233.2(1).

the plan owner makes the election.[69] It is not clear from the CRA's guidance whether a 401(k) plan's designated Roth account is also subject to Canada's foreign asset reporting requirement, although the CRA does mention Roth 401(k) plans in its guidance.

- **No additional tax consequences**. Provided the plan owner complies with the CRA's election and reporting rules, IRA and 401(k) plan balances offer the same tax deferral as RRSPs and RRIFs. Distributions from IRAs and 401(k) plans are also treated the same as distributions from RRSPs and RRIFs.
- **Investments a plan owner will be familiar with**. Upon returning to Canada, a plan owner may continue the investment strategy that they were pursuing with their IRAs and 401(k) plans.
- **Minimal additional paperwork**. A plan owner need not file an election to maintain tax deferral for an IRA, but must file an election each year with the CRA to maintain tax deferral on their 401(k) plans. Only a one-time election is needed to preserve tax-deferral for a Roth IRA. They must also file Form W8-BEN with the financial institution holding their IRA or 401(k) plan before commencing distributions to receive the benefits of the 15% Treaty withholding tax rate (also assuming that their distributions qualify for that rate). Otherwise, there are no additional paperwork requirements compared to those that a U.S. citizen and resident faces.
- **Pension credit**. A Canadian taxpayer age 65 and over during the year may use the pension credit to reduce or eliminate tax on up to $2,000 of "pension income". For those who will not turn age 65 during the year, the credit is only available for "qualified pension income". Generally, "qualified pension income" includes income from a defined benefit pension plan paid in the form of a life annuity. However, the rules governing what types of income qualify for pension credit treatment are complicated and beyond the scope of this article. IRA income does not qualify for pension credit treatment because an IRA is a foreign retirement arrangement under the Act, not a pension plan. However, a 401(k) plan is a pension plan under ITA paragraph 60(j), so in most instances 401(k) income should qualify for the pension credit. In the Jacques decision,[70] the Court ruled that the plan was not a "pension plan" because of a lack of evidence before the Court to establish it as a pension plan, not because a 401(k) plan could not be a pension plan.

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[69] Ibid, note 13, Income Tax Folio S5-F3-C1, Taxation of a Roth IRA, available at https://www.canada.ca/en/revenue-agency/services/tax/technical-information/income-tax/income-tax-folios-index/series-5-international-residency/folio-3-cross-border-issues/income-tax-folio-s5-f3-c1-taxation-roth-ira.html.

[70] Ibid, note 9.

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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. However, 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.[71] A plan owner will need to talk with their independent tax advisor about which withdrawal regime produces higher or lower required withdrawals in their particular case.

  For distributions taken in 2021 the RMD rules require higher withdrawals than the RRIF minimum formula rules:

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

  For distributions taken in 2022 and going forward the RMD rules still require higher withdrawals than the RRIF minimum formula rules, though not by as much:

Plan owner's age	Spouse's age	RRIF minimum	RMD
72	61	3.33%	3.56%
82	71	5.00%	5.21%
89	78	6.17%	7.41%

- **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 considerations. It may be easier for a

[71] 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.

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. As discussed above, Canadian beneficiaries may 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 taxable 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 values of the U.S. and Canadian dollars 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 has not requested it. The RMD rules instead use a severe penalty to encourage compliance with the withdrawal rules. As mentioned above, the CRA allows a plan owner to use a foreign tax credit to partly or fully offset a U.S. penalty tax.
- **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 will not 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,[72] U.S. law does not allow a transfer of RRSP or RRIF money to an IRA.[73]

Plan owners who believe that they may 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.

IRA TO RRSP TRANSFERS

ITA subparagraph 60(j)(ii) governs transfers from an IRA to an RRSP. Only lump sum amounts (not periodic payments) contributed by the plan owner or spouse to an IRA (and received by the plan owner because of the spouse's death, or a divorce) 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.[74]

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

- Simplified Employee Pension (SEP) IRAs. As discussed above (footnote 2), SEP IRAs are a form of pension plan available for employees of small businesses. Employers contribute directly to their employees' individually owned IRAs to fund their employees' pensions.
- Transfers of IRAs where the plan owner has transferred money to their IRA from a 401(k) plan to which their employer, or their spouse's employer, contributed.

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[72] 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.

[73] IRS Private Letter Ruling 9833020, August 14, 1998.

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

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

Considering SEP IRAs, the CRA has said that even though a SEP IRA uses an IRA as its funding vehicle, a SEP IRA is still a "pension plan", not a "foreign retirement arrangement" (i.e. an IRA).[75]

Pension plans are governed by ITA subparagraph 60(j)(i), which allows the transfer of employer contributions to an RRSP. Therefore, even though a SEP IRA will contain employer contributions, it can still be transferred in its entirety to an RRSP.

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

401(K) PLAN TO RRSP TRANSFERS

As noted above, ITA subparagraph 60(j)(i) governs transfers from a "pension plan" to an RRSP. The CRA considers a U.S. 401(k) plan to be a "pension plan" under ITA subparagraph 60(j)(i).[76] However, in Jacques v. The Queen,[77] the Court ruled that amounts received from a plan described by the parties as a 401(k) plan were not superannuation or pension benefits under ITA subparagraph 56(1)(a)(i). The Court noted that there was no expert evidence to establish that the particular plan was a pension plan. In considering this decision it is important for a plan owner's independent tax advisor to confirm that the plan satisfies the requirements for transfer under ITA subparagraph 60(j)(i), and in particular, that it is a pension plan under ITA subparagraph 56(1)(a)(i). The CRA has not 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.[78]

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[75] 2002 RRSP/RRIF Consultation Session, October 28, 2002, page 2.

[76] CRA Documents 2004-0065161E5 and 2004-0071271E5, June 1, 2004 and July 13, 2004.

[77] Ibid, note 9.

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

It is unlikely that a 403(b) or 457(b) plan would be treated differently from a 401(k) plan under ITA subparagraph 60(j)(i). Still, a client should be guided by their independent tax advisor in making any decision to transfer 403(b) or 457(b) money to their RRSP.

The CRA has said that it will allow a plan owner to transfer 401(k) plan money to an RRSP.[79] It also agrees that a plan owner can transfer 401(k) plan money to an IRA, and then transfer the IRA money to an RRSP.[80]

However, ITA subparagraph 60(j)(i) contains a restriction that affects pension plans but not IRAs: the pension plan contributions must have been made while the plan owner (or spousal contributor) was not a Canadian resident. The CRA will not allow a 401(k) plan transfer to an IRA, and subsequent transfer to an RRSP, if the transfer to the IRA was done to avoid the residency requirement.[81] This requirement could be troublesome for Canadians who worked for U.S. employers, participated in those employers' 401(k) plans, but remained Canadian residents throughout.

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

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

- If the plan owner is transferring a 401(k) plan balance, they must have been a U.S. resident for U.S. income tax purposes when the contributions to the plan were made, and cannot have been a Canadian resident for tax purposes for any period of time during which their employer was contributing to their 401(k) plan.

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

[80] CRA Document 9805625, June 23, 1998.

[81] CRA Document 9641365, March 3, 1997.

- The plan owner must be a Canadian resident for Canadian income tax purposes when the transfer to the RRSP is made.
- The plan owner should regard their move to Canada as permanent, with no move back to the U.S. as a resident for income tax purposes.

Withdraw money – U.S. tax considerations

- The plan owner takes a lump sum withdrawal from their IRA or 401(k) plan. There is 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 the appearance that they are taking periodic payments. Although periodic payments from an IRA or 401(k) plan will attract only 15% IRS withholding tax, the payments will be income for Canadian tax purposes, and will not be eligible for deposit to the plan owner's RRSP[82] other than by using the plan owner's existing RRSP contributing room.
- The IRA trustee or 401(k) plan administrator will withhold 30% of the withdrawal for U.S. federal income tax purposes (if the plan owner has not already submitted IRS Form W-8BEN with the trustee or administrator, they will need to include it with their withdrawal request documents). If the plan owner withdraws the entire US$100,000, and if the trustee or administrator charges no fees, the plan owner will receive US$70,000, with US$30,000 withheld for the IRS.

WITHDRAW MONEY – CANADIAN TAX CONSIDERATIONS – RRSP CONTRIBUTION RULES

- If the plan owner does not already have an RRSP, they will 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 cannot be carried forward to later years. If an amount up

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

to or equal to the gross withdrawal is not 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 or annuity.
- The plan owner will need to borrow the Canadian equivalent of US$30,000 or come up with that amount from other sources to bring the total contribution to their RRSP up to the Canadian equivalent of US$100,000. Having deposited this amount to their RRSP, the plan owner will be able to deduct it from income, thereby eliminating Canadian taxation on the withdrawal.

CONTRIBUTION DEADLINES AND RESTRICTIONS

- Plan owners age 72 or older during the year may not use this strategy because they may not own RRSPs. The contribution may only be made to the plan owner's personal RRSP, not to a RRIF or annuity.[83]
- 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.
- If the plan owner will not 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

- As discussed above, to offset the U.S. tax on the withdrawal, the plan owner will have to file a U.S. nonresident tax return (IRS Form 1040NR) to report the withdrawal (requesting a transcript from the IRS), calculate the tax owing on the withdrawal, and claim a refund, if applicable.
- After determining their final U.S. tax liability, they may use a foreign tax credit to partly or completely offset their U.S. income tax liability against their Canadian income tax liability.

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

SOME PLANNING POINTS

- Whether a plan owner will benefit from transferring IRA or 401(k) plan money to their RRSP will depend on the plan owner's individual circumstances.
- The plan owner must speak with their own independent tax advisor before initiating a transfer of IRA or 401(k) plan money to their RRSP. Such an advisor should be well versed in how IRAs, 401(k) plans and RRSPs work. The transfer requires advanced planning to make sure that it can be accomplished in a tax neutral way.
- If the plan owner decides to transfer IRA or 401(k) plan money to their RRSP, they may need to borrow to make up for the U.S. withholding tax, or may need to liquidate other assets. The plan owner should be prepared for this possibility in advance.
- If, after considering the withdrawal, the plan owner expects that they cannot 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 (subject to completing all withdrawals before the end of the year the plan owner turns age 71). Care must be taken to ensure that the withdrawals do not resemble or constitute periodic payments. Use of a non-business (individual) foreign tax credit may not be spread over more than one year.

CONCLUSION

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

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

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