IG PRIVATE WEALTH MANAGEMENT

Canadians with U.S. retirement plans: tax and investment considerations when returning home

For Canadians living and working in the U.S., there are several things to consider – this includes applying for a visa and figuring out what the Canadian tax implications and U.S tax implications of living and working abroad would be. There are also many things to consider when returning home. One of the most common questions that arise when people return to Canada is figuring out what to do with their U.S. retirement plan (such as the 401(k) and Individual Retirement Account) to which they contributed while living abroad.

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In this article, we will cover the following:

1. Your options
2. The advantages and disadvantages of transferring a U.S. pension plan to Canada
3. Three critical steps to consider when seeking to transfer a U.S. pension plan to Canada
4. Two examples of individuals considering transferring their U.S. pension plans

A 401(k) plan is a tax-deferred retirement plan that is similar to a defined contribution pension plan. An employee and an employer may both contribute to the plan. The investment income accrued in the 401(k) account is tax deferred until the funds are withdrawn from the plan. Per Canada's Income Tax Act ("the Act"), a 401(k) is generally considered to be an employee benefit plan.

An Individual Retirement Account (or "IRA") is a statutory tax-deferred retirement account much like an individual RRSP in Canada. The employee funds the plan with pre-tax dollars. The contributions and income in the plan are tax deferred until withdrawn from the plan. For Canadian tax purposes, an IRA is considered a foreign retirement arrangement under the Act.

Your options

Generally, there are three options for Canadians when returning to Canada:

1. **Leave the plan as is and take withdrawals once retired;**
2. **Take a lump sum withdrawal; or**
3. **Withdraw the funds and contribute to a Canadian plan such as an RRSP**

1. LEAVE THE PLAN AS IS

The Canada-US Tax Treaty[i] and the Act allows for the tax-deferred treatment of the income accrued in the 401(k) or IRA until distributions are made from the plan. Distributions are generally required to commence no later than the year in which the plan owner attains age 72. The deemed disposition and deemed acquisition rules which may apply to many assets when moving to Canada do not apply to these plans.

When a Canadian resident receives payments from a US-based pension plan or annuity, he or she will be subject to U.S. tax and will also required to include the gross amount of the distribution as pension income on their Canadian returns. As the pension plan arises in the U.S., the U.S. has the first right to tax these payments[ii]. If the payment is being made to a non-resident, the plan administrator will be required to withhold U.S. tax from these payments. Generally, a lump sum payment will be subject to the regular rate of 30% withholding tax. However, this rate may be reduced to 15% if the distribution qualifies as a periodic pension payment[iii]. The plan administrator would be able to clarify the rate at which they are required to withhold. Before the 15% rate can apply, the Canadian resident will have to file IRS form W-8BEN with the plan administrator.

For Canadian tax purposes, the Canadian resident may claim a foreign tax credit for the U.S. tax paid to offset in whole or in part the Canadian tax payable. The foreign tax credit is limited to the U.S. tax paid or the amount of Canadian tax that would otherwise be payable as a result of the U.S. sourced income. As a result, double tax is generally mitigated but the higher rate between the two jurisdictions will prevail and generally that is the Canadian rate.

2. LUMP SUM WITHDRAWAL

A lump sum withdrawal (without a transfer to a Canadian RRSP which is addressed next) is not unlike unwinding or deregistering an RRSP all at once and generally would not be recommended. As noted previously in this article, a withdrawal from a U.S. retirement plan is subject to taxation in both the U.S. and Canada. Foreign tax credits can be used to mitigate any potential double taxation.

3. WITHDRAW THE FUNDS AND CONTRIBUTE TO A CANADIAN RRSP

When a Canadian resident has participated in a U.S. retirement plan but plans to permanently retire in Canada, he or she may wish to consider transferring those funds to Canada upon their return. There is no direct rollover available to transfer the U.S. retirement plan to an RRSP. Whether such a transfer is advisable hinges on whether all or most of the U.S. tax payable can be claimed as a foreign tax credit and utilized in full against Canadian tax payable as a result of the withdrawal.

[i] Article XVIII(7) of the Canada-US Tax Convention

[ii] Article XVIII(1) of the Canada-US Tax Convention

[iii] Article XVIII(2) of the Canada-US Tax Convention

Advantages and disadvantages of transferring your U.S. pension plan to Canada

Let's take a closer look at the advantages and disadvantages of transferring your U.S. pension plan to Canada:

Advantages

- Simplifies management of retirement portfolio
- U.S financial institutions may not be able to provide investment advice
- A larger portfolio in Canada may increase access or expand investment options
- Creates a natural currency hedge for your Canadian retirement expenses (incurred in Canadian dollars)
- May help avoid U.S. estate tax

Disadvantages

- Lump sum withdrawal will result in U.S. tax and this tax may not be recoverable by claiming a foreign tax credit
- An early withdrawal penalty may also apply which may not be recoverable
- In the year of withdrawal, the Canadian taxpayer may be subject to OAS clawback and Alternative Minimum Tax.

Three critical steps to consider when seeking to transfer a U.S. pension plan to Canada

When considering how best to proceed, there are three critical steps to analyse:

1. **Determine if the U.S. retirement plan can be transferred to a Canadian RRSP**
2. **Determine what U.S. tax will be paid as a result of the withdrawal**
3. **Determine if the U.S. tax can be fully recovered by claiming a foreign tax credit for Canadian tax purposes**

STEP 1: DETERMINE IF THE U.S. RETIREMENT PLAN CAN BE TRANSFERRED TO A CANADIAN RRSP

The lump sum withdrawal from the U.S. plan is fully included in income for Canadian tax purposes. However, a deduction may be available for a lump sum that is transferred to an RRSP. In the case of an IRA, the full taxable amounts withdrawn from the IRA, which are sourced from the plan member's own contributions, can generally be transferred to the RRSP without using up existing RRSP contribution room. If the withdrawal is from a 401(k), the full amount withdrawn can be contributed to the RRSP (without using up RRSP contribution room) provided it is attributable to services rendered by an individual and his or her spouse when they were not resident in Canada. If the withdrawal is from a 401(k) but attributable to services rendered while resident in Canada, then RRSP contribution room is required to make the contribution. In order to qualify for this deduction, CRA has allowed for the lump sum withdrawal to be spread over two years but not three.

The contribution of the net amount received from the withdrawal in the U.S. (lump sum net of withholding tax) will not result in a deduction that fully offsets the income inclusion. As such, it may be necessary for the Canadian resident top up the contribution to the RRSP using other sources of funds.

Contribution deadline

The contribution must be made no later than 60 days following the year in which the withdrawal was made except for those individuals who turn 71 in the year of withdrawal. In that case, the contribution must be made by December 31st of the year of the withdrawal. The transfer to the RRSP is not available to individuals who are 72 and older as the contribution can only be made to an RRSP not a RRIF or an annuity.

STEP 2: DETERMINE WHAT U.S. TAX WILL BE PAID AS A RESULT OF THE WITHDRAWAL

As indicated earlier, the Canadian resident will need to determine what rate of tax will apply in the U.S. In addition to the withholding tax (30% or 15%) a 10% early withdrawal penalty may also apply if the plan holder is younger than 59 ½ years of age. The 10% early withdrawal penalty will not be applied by the plan administrator, but the Canadian resident will have to file a Form 1040NR with the IRS enclosing a cheque for the 10% penalty tax. The withholding tax and penalty tax cannot be avoided even when the funds are transferred to a Canadian RRSP as the contribution to the RRSP is not deductible for U.S. tax purposes.

STEP 3: DETERMINE IF THE U.S. TAX CAN BE FULLY RECOVERED BY CLAIMING A FOREIGN TAX CREDIT FOR CANADIAN TAX PURPOSES

The final step in determining whether the transfer is worthwhile is determining if the U.S. tax payable as a result of the withdrawal can be fully offset by claiming a foreign tax credit against Canadian taxes payable. To the extent that the foreign tax cannot be recovered by claiming a foreign tax credit for every dollar of U.S. tax paid, the transfer would not make sense as it would result in double tax – U.S. tax payable now upon the transfer and Canadian tax when the funds are withdrawn from the RRSP in retirement.

If the full amount withdrawn from the U.S. plan is transferred to the RRSP, and the full income inclusion is offset, you may ask, how can the Canadian resident claim a foreign tax credit for the U.S. tax that is paid? In determining the foreign tax credit that can be claimed, the deduction as a result of the transfer to the RRSP is not taken into consideration.

Two examples of individuals considering transferring their U.S. pension plans

EXAMPLE 1:

Mr. Canuck just turned 60 and has recently returned to Canada after many years away. He is not a U.S. taxpayer. He is a high-income earner with employment income of $250,000. He has $60,000 in his 401(k). The plan administrator has indicated that they will apply the 30% withholding tax. He decides to transfer his 401(k) to a Canadian RRSP. He receives a net cheque from the U.S. plan administrator for $42,000 and Mr. Canuck transfers another $18,000 of his personal money to the RRSP. For U.S. tax purposes, the withdrawal will result in $18,000 of U.S. tax. The amount withdrawn from the U.S. plan will be fully included in pension income for Canadian tax purposes. However, a deduction is claimed for the full amount of $60,000 that has been transferred to the RRSP. Assuming Mr. Canuck lives in Ontario and is in the highest tax bracket, he can recover the full $18,000 of U.S. tax paid by claiming a foreign tax credit against Canadian tax payable. For Mr. Canuck, the transfer does make sense.

Any foreign tax that cannot be recovered by claiming a foreign tax credit is essentially wasted as there is no ability to carry back or carry forward these credits.

A note about timing

Timing can greatly influence whether the transfer makes sense. Generally, it is easier to transfer these plans prior to retirement when the Canadian resident has significant amounts of Canadian sourced income. It is also easier to transfer these funds when the early withdrawal penalty does not apply. It may also be possible to structure the transfer over two years (if the U.S. plan is very large) or multiple years (where the Canadian resident has multiple U.S. retirement plans).

U.S. taxpayers

A U.S. citizen or U.S. green card holder who resides in Canada is subject to both U.S. tax and Canadian tax on their world-wide income.

EXAMPLE 2:

Ms. Eagle is a U.S. citizen who has recently moved to Canada. She is 56 years of age and has accumulated $200,000 in an IRA. As a U.S. citizen she will be subject to U.S. tax on the full withdrawal from the IRA. Her marginal tax rate in the U.S. is 35% and because she is not yet 59 ½, the 10% early withdrawal penalty will also be applied. She will pay $90,000 of U.S. tax as a result of the withdrawal. If she were to transfer $200,000 to her RRSP, the income inclusion on her Canadian tax return would be fully offset. However, unless her marginal tax rate in Canada is greater than 45%, she will not be able to recover all of the U.S. tax that is paid as a result of the withdrawal. The transfer in her case, is not recommended unless she has significant amounts of Canadian sourced income.

There are many things to consider, where should I start?

The analysis as to whether the transfer of the U.S. retirement plan to Canada makes sense is complex and should not be avoided. Several factors are at play which can have an impact as to whether the transfer is worthwhile. The analysis starts with answering the following questions:

- What type of U.S. retirement plan is it?
- Are you a U.S. citizen or U.S. green card holder? Or did you work in the U.S. with a visa?
- What is your age?
- What is the value of the U.S. account?
- What sources of income do you currently have?
- Were you a non-resident when you contributed to the U.S. retirement plan?

A pro-forma tax calculation by an independent tax advisor is generally warranted to confirm that all the U.S. tax paid as a result of the transfer can be recovered. Ultimately, a Canadian resident will want to carefully consider whether it is better to leave the money where it is currently or move it to an RRSP with the help of their financial advisor and their accountant. For more information on this topic, please speak with your IG Consultant.

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Mariska is Director, Tax & Estate Planning at IG Wealth Management, where she specializes in providing tax and estate planning advice to high net worth clients and clients with cross-border tax issues. Mariska is a Chartered Professional Accountant who completed the In-Depth Tax Program and the Advanced Tax Courses. Prior to joining IG in 2015, Mariska spent 13 years working for a large accounting firm in Winnipeg where she provided Canadian tax advice to business owners and high net worth individuals. Mariska is a member of the Canadian Tax Foundation, has her CERTIFIED FINANCIAL PLANNER designation and is a Trust & Estate Practitioner, certified by the Society of Trust & Estate Practitioners (STEP). She is actively involved as Treasurer of the Winnipeg branch of STEP and regularly speaks to a variety of audiences about tax matters.

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