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Wealth Without Borders

Your Cross Border Newsletter

The purpose of this newsletter is to share cross-border wealth management news and insights with our cross border clients and colleagues.

OPTIONS FOR US RETIREMENT ACCOUNTS

Our team has recently witnessed an influx of people moving to Canada. The reasons for moving vary, but include anxiety over the future of US H1-B visa caps, concerns about the Covid pandemic and flexible work from home policies. We frequently receive inquiries from prospective clients about the financial planning issues to consider with US retirement accounts.

We Care for Orphaned Clients

Many of our cross-border clients have found themselves in the unfortunate situation of being 'orphaned' by their existing US based advisors, as most US investment advisory firms are not properly registered to do business in Canada. Typically, when clients provide their new Canadian address to their US based advisor, they are notified that they have 30 days to find a new advisor or their accounts will be liquidated, triggering taxes and penalties. These individuals are often caught off guard and panic. Steele Wealth Management (SWM) can help calm the panic and provide advice to help orphaned clients.

This edition of WWB explains the options that are available for Individual Retirement Accounts when moving to Canada. It should be noted that everyone's situation is different and at SWM we assess our clients' unique situation before developing a comprehensive financial, tax, and investment plan that includes the best option for the client's specific US retirement accounts.

Obligation to File Tax Returns

The issues to consider for each option are different depending on the country in which the individual is taxed. Individuals who are classified as US persons are required to file US tax returns and pay income tax on their worldwide income. A US person includes a US citizen, a US green card holder or a US resident. In Canada, the obligation to file an income tax return and pay income tax on worldwide income is based on tax residency. Generally, Canadian tax rules base tax residency on permanent home location, personal ties such as the location of family, the location of personal property and economic ties such as the place of employment. An individual may have an obligation to file a tax return in both countries.

Types of US Individual Retirement Accounts

There are essentially two types of Individual Retirement Accounts (IRAs): a traditional IRA and a Roth IRA. In a traditional IRA, contributions may be tax deductible for US tax purposes, funds in the plan grow tax-free and withdrawals are taxable. A Roth IRA does not provide tax deductions on contributions but does allow retirement savings to grow tax-free and qualified distributions after the age of 59½ are exempt from US tax. There are three options for IRAs when moving to Canada.

OPTION #1 – CONTINUE TO HOLD THE IRA

For most individuals moving to Canada, the option that is most logical is to continue holding their IRA. This is possible by becoming a client of SWM in partnership with Raymond James (USA) Ltd (RJLU). We are a Canadian based US registered investment firm offering integrated cross-border wealth management solutions.

Current Rates & Data

Govt of Canada

Term	Rate
90 day	0.10%
1 year	0.19%
2 year	0.30%
5 year	1.02%
10 year	1.54%
30 year	2.00%

U.S. Treasury

Term	Rate
90 day	0.02%
1 year	0.07%
2 year	0.15%
5 year	0.82%
10 year	1.60%
30 year	2.35%

Canada Prime Rate

2.45%

U.S. Prime Rate

3.25%

Exchange Rates

Pair	Rate
CAD/USD	0.802
USD/EUR	1.189
JPY/USD	109

Clients of RJLU are able to hold investment accounts in both the US and Canada. Therefore, a US domiciled IRA account can be managed for a resident in Canada without issue.

This is beneficial because the Canada-US Tax Treaty allows a Canadian resident to hold an IRA in the US and receive the same tax-deferred treatment that would be available if still living in the US. Generally, it's advantageous to keep an IRA as these plans have more tax-deferral benefits than Canadian RRSPs and RRIFs. Under this option, our client can let the IRA grow without tax until required to take out annual Required Minimum Distributions (RMDs) after turning age 70. This strategy works as follows:

US Withholding tax: By continuing to hold the IRA, there isn't an event that triggers withholding tax when the client moves to Canada. There will be US non-resident tax withheld on distributions and on each annual RMD. The distributions are subject to a 30% US non-resident withholding tax, unless a tax treaty specifies a different rate. The Canada-US treaty gives a reduced 15% withholding rate for periodic pension payments if the IRS form W8BEN is filed. For a client who continues to be considered a US person under US tax law when the RMDs are made, withholding is not necessary if the payment is made to a US account.

Income tax: There is no income tax triggered until withdrawals are made from the IRA. The RMDs are included as income for Canadian tax purposes. For individuals who continue to be considered a US person under US tax law, the amount is included as income on both Canadian and US tax returns. The US withholding tax may be claimed on the Canadian income tax return as a foreign tax credit. The foreign tax credit may be used to offset the Canadian income tax liability on other sources of income. However, if the US tax withheld exceeds the Canadian income tax liability, the remainder of the foreign tax credit is lost. A foreign tax credit can only be used in the year of the withdrawal and cannot be carried forward.

Convert the traditional IRA to a Roth IRA prior to moving: Before moving and establishing tax residency in Canada, converting all or a portion of a traditional IRA to a Roth IRA may be beneficial to create an investment account that is not subject to Canadian taxation at withdrawal. This strategy recognizes a taxable US income inclusion before becoming a Canadian taxpayer and converts the before-tax accounts into after-tax accounts. Although US tax is payable on the conversion, the combined lifetime tax liability for both countries may be minimized. Under this strategy, the fair market value of the traditional IRA converted to a Roth IRA is included in US taxable income in the year the conversion takes place. US tax is payable on the conversion before the individual moves to Canada. The converted Roth IRA is then considered a pension under the Canada-US Tax treaty. This means that the growth and subsequent withdrawals from a Roth IRA would not be subject to tax in Canada or in the US, provided the earnings are held for at least five years prior to withdrawal and the withdrawals happen after the age of 59½. Another benefit is there are no RMDs for Roth IRAs, meaning the amount withdrawn can be as little or as much as the individual wants once they turn 59½ years old.

To ensure that income earned within a Roth IRA is deferred and considered a pension under the treaty, an election must be made by April 30th after the year the client becomes a resident of Canada. No contributions or conversions may be made to the Roth IRA after becoming a Canadian tax resident; otherwise, the tax-free status is tainted. This strategy is appropriate where the client is expected to be in a higher tax bracket in retirement while living in Canada. Generally, tax rates in the US are lower than those in Canada. So the client pays tax on the conversion amount at a lower US tax rate and then has no Canadian tax at higher rates when withdrawals are made. Tax is paid at a lower tax bracket in order to benefit from tax-free withdrawals later. By converting, the total lifetime tax paid is usually lower than if the traditional IRA had been kept.

For the majority of clients, the most beneficial strategy is to continue to hold their IRAs even when moving to Canada. This strategy may result in the least amount of tax, withholdings and penalties. **The ability to continue to hold an IRA is available for cross border clients of Steele Wealth Management.**

OPTION #2 - CLOSE THE IRA AND WITHDRAW THE FUNDS

When a client is orphaned by their US broker and does not take action, the IRA is liquidated and the funds are mandatorily withdrawn as a lump sum. This option is useful if there are immediate cash needs. However, the requirement to pay withholding tax and potentially early withdrawal penalties often makes this option unsuitable. An individual may face the following tax implications if the IRA is closed:

US Withholding tax: If the owner of the account is a resident for Canadian tax purposes, the lump-sum withdrawal from the IRA is considered US source income, subject to a 30% US non-resident withholding tax. Plan administrators are required to withhold 30% of the withdrawn amount, unless a tax treaty specifies a different rate. The Canada-US treaty gives a reduced 15% withholding rate for periodic pension payments, however lump-sum withdrawals do not normally benefit from this. Some plan administrators may withhold at the lower rate if the IRS form W8BEN - Certificate of Foreign Status of Beneficial Owner is filed with them. This form certifies the foreign status of the owner of the IRA in order to take advantage of reduced withholding rates in the Canada-US tax treaty. It is important to check with the particular plan administrator for their interpretation of the withholding rate rules. If the owner of the IRA is considered a US person for US tax purposes, there is no requirement for withholding tax.

US Early Withdrawal Penalties: If the owner of a traditional IRA is under the age of 59½ years at the time of the withdrawal, an additional 10% early withdrawal penalty is assessed on the value of the distribution. If the owner of a Roth IRA is under the age of 59½ years at the time of the withdrawal, an additional 10% early withdrawal penalty is assessed on the earnings withdrawn from the plan. The US retirement plan administrator is not responsible for withholding these penalties. It is the owner of the IRA who must file the appropriate form and pay the penalty to the IRS.

Income tax: For a Canadian tax resident, the gross amount withdrawn from the IRA (before withholding tax or penalties) must be included in Canadian taxable income in the year the funds are received. Similar to Option 1, the US withholding tax and penalty may be claimed on the Canadian income tax return as a foreign tax credit to offset a Canadian tax liability on other sources of income. However, if the US tax withheld exceeds the Canadian income tax liability, the remainder of the foreign tax credit is lost. A foreign tax credit can only be used in the year of the withdrawal and cannot be carried forward. For individuals who are considered a US person under US tax law, the gross amount withdrawn is included as income on both Canadian and US tax returns. This double taxation may be eliminated through the application of foreign tax credits.

It is important to be very careful when considering collapsing and withdrawing the funds from an IRA because the tax treatment tends to be detrimental in most situations.

OPTION #3 - CLOSE THE IRA AND TRANSFER THE PROCEEDS TO AN RRSP

It may be possible to transfer an IRA into a Canadian Registered Retirement Savings Plan (RRSP). The Canadian Income Tax Act contains specific provisions to allow individuals who are Canadian residents for tax purposes to transfer an IRA to an RRSP on a tax-deferred basis. Under the right circumstances, this may be a worthwhile option to consider if the individual is not a US person under US tax law. An individual may face the following tax implications if the IRA is transferred to an RRSP:

US Withholding tax: As explained in Option 2 above, if the owner of the account is a Canadian tax resident, the lump-sum withdrawal from the IRA is considered US source income and subject to US non-resident withholding tax. The discussion about reducing the withholding rate is the same as well. If the owner of the IRA is considered a US person for US tax purposes, there is no requirement for withholding tax.

US Early Withdrawal Penalties: As explained in Option 2 above, if the owner is under the age of 59 ½ at the time of the withdrawal, an additional 10% early withdrawal penalty is payable on the value of the distribution (for a traditional IRA) and the value of the earnings (for a Roth IRA).

Income tax: For a Canadian resident, the gross amount withdrawn (before withholding tax or penalties) must be included as Canadian taxable income in the year the funds are received. However, if specific provisions are met and the funds from the IRA are transferred to an RRSP, the resulting tax deduction may offset the income inclusion amount. There are several conditions that must be met:

1. The payment from the IRA must be a lump-sum amount,
2. The payment must be fully taxable in Canada and included in income in the year of transfer,
3. The amount transferred must be designated as such on Schedule 7 of the Canadian T1 tax return in the year of transfer,

4. The taxpayer must be under age 71 in order to transfer to an RRSP, and
5. The transferor must be a Canadian resident for tax purposes when the transfer to the RRSP is made.

This is considered a transfer and therefore it does not affect regular RRSP contribution room. The transfer cannot be made to a spousal RRSP. To make the tax-deferral work, the transfer into the RRSP must be made in the year or within 60 days after the end of the year that the IRA is withdrawn.

The US withholding tax and potential early withdrawal penalty mean that only a portion of the funds withdrawn from the IRA will be available for an RRSP transfer. To fully offset the income inclusion, the transfer to the RRSP must be equal to the gross amount withdrawn from the IRA. This requires additional funds from other sources to provide a top up.

Similar to Option 2, the US withholding tax and penalty may be claimed on the Canadian income tax return as a foreign tax credit to offset a Canadian tax liability on other sources of income. However; a foreign tax credit can only be used in the year of the IRA withdrawal and can't be carried forward. If the entire foreign tax credit cannot be used, this may mean that the IRA funds transferred to an RRSP are subject to double taxation: once with the withholding tax and again when the RRSP or RRIF funds are received.

Although an IRA may be transferred tax-free to a Canadian RRSP, the rules regarding the transfer are complicated and not advisable if the strategy results in double taxation. This option may make sense if the individual intends to retire and stay in Canada for the remainder of their life. However, the strategy will not make sense if future retirement plans include moving back to the United States.

CONCLUSION

Careful consideration should be made of the options and applicable issues that are available for Individual Retirement Accounts when moving to Canada. A plan that considers each individual's unique circumstances will ensure that the appropriate recommendation is made. **The Steele Wealth Management team can help cross-border clients to effectively consolidate and manage their retirement plans as part of their overall investment plan. We can create a managed investment strategy, comprehensive retirement income and estate plan to integrate a client's entire portfolio of US and Canadian investments.**

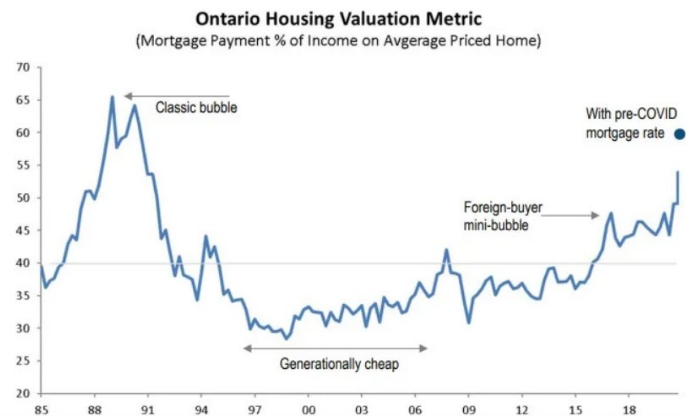
CROSS BORDER TIDBITS

NEXT STOP: CANADA

Canada announced its most ambitious immigration plan in history after falling short of targets during the Covid-19 Pandemic. Revised immigration targets for 2021-2023 are greater than 400,000 people per year. Interestingly, the all-time high in Canadian immigration history came in 1913 when Canada welcomed 401,000 newcomers. At the time, this equated to 5% of the population of Canada! We look forward to helping new Canadians with their cross border investments and tax planning!

HOT HOT HEAT: CANADIAN REAL ESTATE PRICES CLIMBS HIGHER

A hot Canadian real estate market has continued in 2021. US tax filers living in Canada may be eligible for a principal residence exemption on their US return on $250,000 (if single) or $500,000 (as a couple) when a property is sold.



Meanwhile, Canadian tax filers may be entitled to an exemption if the Principal Residence Exemption rules are met. We have been working with our US clients on tax planning strategies to minimize the potential impact of the IRS cap on exemptions. If you have any questions please get in touch!

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