# CROSS-BORDER PLANNING FOR CANADIAN REGISTERED RETIREMENT PLANS

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Each year, many Canadians choose to move to the United States for various reasons, including, *inter alia*, employment opportunities, retirement destinations, and lower tax rates. Whatever the reason may be, there are several important planning questions to consider before making the move. The purpose of this paper is to address one such key consideration: the cross-border tax implications in respect of registered retirement plans.

This paper is divided into three parts. The first part analyzes the Canadian taxation of distributions from Canadian registered retirement plans, upon the plan owner's death, to a beneficiary who is a non-resident of Canada. The second part discusses how a Canadian who moves south of the border and becomes a U.S. citizen or resident alien would be taxed by the U.S. tax system vis-à-vis the distributions from his or her Canadian registered retirement plans. Conversely, the final part of the paper provides an overview of the U.S. taxation of a U.S. non-resident alien with respect to distributions from his or her U.S. retirement plans.

## I. CANADIAN TAXATION OF CANADIAN REGISTERED RETIREMENT PLANS UPON DEATH

This part of the paper looks at the Canadian taxation of the payment from a registered retirement plan (namely, a Registered Retirement Savings Plan ("RRSP") and Registered Retirement Income Fund ("RRIF")) upon the plan owner's death, to a beneficiary who is a non-resident of Canada. In particular, it addresses whether a non-resident beneficiary of such registered plan would be subject to any withholding tax on such payment

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in light of his or her residency status — an issue that often confuses taxpayers and their financial advisors.

The answer is quite simple: there is no withholding tax on the payment of the plan value, as of the owner's death, to a non-resident beneficiary under Canada's *Income Tax Act*.[1] The *Income Tax Act* requires such tax to be withheld only with respect to the payment made out of a registered plan to a non-resident beneficiary that would, if such beneficiary were a resident of Canada, be included in his or her income for the year of receipt. Moreover, under the *Income Tax Act*, the date-of-death value of a registered plan is included in the income of the deceased plan owner, unless the income inclusion regarding such value is transferred to the recipient beneficiary by way of rollover to a qualifying beneficiary or payment to a spouse or a common-law partner as a successor annuitant. In other words, where the date-of-death plan value is taxed to the deceased plan owner and is not included in the income of the recipient beneficiary, there is no income tax payable in respect of such value by the recipient beneficiary in the first place and therefore there is no need or basis for the Part XIII tax withholding requirement, otherwise it would give rise to double taxation.

As simple as it may sound, however, the above principle is occasionally overlooked. For instance, a financial institution recently withheld Part XIII tax on the full value of a registered plan (the sole designated beneficiary of which was a non-resident of Canada) on a misguided position that it was required by law to withhold such tax on the payment due to the beneficiary's non-residency. The institution therefore forced the beneficiary (the only child of the deceased plan owner) to unnecessarily wait until her mother's estate paid income tax in respect of the plan and then file her own Canadian tax return for the sole purpose of obtaining a refund for the withheld amount.

Considering the importance of fully understanding the tax liability for a registered retirement plan upon death in a situation involving non-resident beneficiaries, and in the interest of providing future reference for estate practitioners who may face difficulties in dealing with financial institutions in light of the above issue, this part of the paper explains the relevant principles. It begins by providing a general overview of the rules relating to taxation on death for registered plans — specifically, the RRSP and RRIF. It then discusses the nature

1. R.S.C. 1985, c. 1 (5th Supp.).

and application of the Part XIII tax withholding requirement under the *Income Tax Act* with respect to the payment of registered plan proceeds to non-resident beneficiaries. For the purpose of this part of the paper, it is assumed that there are sufficient assets in the plan owner's estate to satisfy the tax obligation in connection with the plan proceeds.

## 1. Taxation of Registered Plans on Owner's Death

### *(a) Registered Retirement Savings Plan*

The general rule under subsec. 146(8.8) of the *Income Tax Act* is that the deceased owner of a RRSP is deemed to have received, immediately before death, the full fair market value of the proceeds in the RRSP as of the time of death. Such date-of-death value is therefore included in the deceased owner's income and must be reported in his or her terminal return for the year of death.

Any increase in the value of the RRSP after the plan owner's death, on the other hand, is included in the income of the designated beneficiary who receives the proceeds or, where there is no beneficiary named, the deceased plan owner's estate, for the year of receipt.

Exceptions exist, however, with respect to the general rule regarding the income inclusion of the date-of-death plan value. With respect to matured RRSPs (which are quite uncommon since most, if not nearly all, RRSP owners choose to convert their RRSPs into RRIFs at age 71), the deceased plan owner's spouse or common-law partner who is the sole designated beneficiary becomes the successor annuitant and receives future annuity payments from the plan in the place of the deceased owner. Thus the plan automatically continues without its date-of-death value being included in the deceased owner's terminal return, and the continuing annuity payments to the spouse or the common-law partner are included in the income of such successor owner. When the spouse or common-law partner is not the sole designated beneficiary of a matured RRSP, then he or she becomes the successor owner in respect of his or her share of the remaining annuity payments, and only the amount of such share is not included in the deceased owner's terminal return. If the spouse or common-law partner is not designated as beneficiary, but is either entitled to the plan under the terms of the deceased owner's will or is the sole beneficiary of the deceased owner's estate, then the spouse or common-law partner and the legal representative of the deceased's estate can jointly elect in writing for the spouse or common-law partner to still become the successor owner of the plan, thereby transferring the income inclusion of the plan value from the deceased owner's terminal return.

Moreover, where the proceeds of a matured RRSP are received by a qualified beneficiary as a result of the owner's death, such date-of-death amount qualifies as a "refund of premiums" and, pursuant to subsec. 146(8.9) of the *Income Tax Act*, the legal representative of the deceased owner's estate has the option of claiming a reduction with respect to the date-of-death plan value from the deceased owner's terminal return by the amount paid to the qualified beneficiary. Such amount is then included in the recipient beneficiary's return for the year of receipt. In other words, the income inclusion is transferred from the deceased plan owner to the qualified beneficiary, resulting in the shifting of the tax burden vis-à-vis the plan value. Where the qualified beneficiary is not designated as beneficiary on an RRSP and the plan value is thus paid to the deceased owner's estate to be distributed to such beneficiary in accordance with the will or the rules of intestacy, both the legal representative of the deceased owner's estate and the recipient qualified beneficiary need to make the joint election, by way of filing Form T2019, to designate the amount of the plan proceeds received by such beneficiary from the estate as a refund of premiums. Such amount is then taxed in the hands of the qualified beneficiary.

The qualified beneficiary includes the deceased plan owner's spouse, common-law partner and financially dependent child or grandchild. A child or grandchild is considered financially dependent if he or she was ordinarily residing with and dependent on the deceased owner, and his or her net income for the year preceding the year of the owner's death was less than the basic personal amount for such year, or not more than the sum of the basic personal amount and the disability amount in the case of a dependent child or grandchild who has a mental or physical infirmity.

Once the proceeds of the RRSP are paid as a refund of premiums to the qualifying beneficiary and the reduction with respect to the payment is made from the deceased owner's terminal return, such amount is now taxable in the hands of the recipient beneficiary. There is a further option for the recipient beneficiary to claim a deduction under para. 60(l) of the *Income Tax Act* to defer paying tax on the refund of premiums by transferring (or "rolling over") such amount to the beneficiary's registered plans, including, but not limited to, RRSPs, RRIFs, or registered disability savings plans ("RDSP"), or to an issuer to buy an eligible annuity, by the specified timelines. This tax-deferred rollover option is available to a deceased plan owner's spouse, common-law partner and financially dependent child or grandchild who is dependent because of a mental or physical infirmity.

### *(b) Registered Retirement Income Fund*

The rules for taxation on death for RRIFs are very similar to the rules for RRSPs. Pursuant to the same general rule, in fact, the date-of-death value of the proceeds in the RRIF is reported in the deceased owner's terminal return and is not included in the income of the recipient beneficiary. The post-death increase in the fund value, on the other hand, is included in the recipient designated beneficiary's estate or, where no beneficiary is named, the deceased owner's estate, for the year of receipt.

Where the spouse or common-law partner becomes the successor fund owner in accordance with beneficiary designation or the terms of the deceased owner's will, the fund continues without its date-of-death value being included in the deceased owner's terminal return.

As is the case for RRSPs, where the proceeds of an RRIF become payable to the qualified beneficiary, such amount qualifies as a "designated benefit" and the legal representative of the deceased owner's estate can claim a reduction for such amount from the deceased owner's terminal return and redistribute same to the taxable income of the recipient qualified beneficiary. The recipient beneficiary who is the deceased owner's spouse, common-law partner or child or grandchild who is financially dependent due to mental or physical infirmity can then rollover the designated benefit amount to their registered plans, including, but not limited to, RRSPs, RRIFs, or RDSPs, or to an issuer to buy an eligible annuity by the specified timelines. The rollover amount, however, is reduced by the amount of minimum payment that is to be included in the deceased's terminal return.

In sum, as a general rule, the date-of-death value of an RRSP or an RRIF is included in the income of the deceased owner and is not taxable to the beneficiary who receives the proceeds as a result of the owner's death. This is unless the proceeds are paid to the qualified beneficiary as a refund of premiums or designated benefit and the option to reduce such amount from the deceased owner's terminal return is exercised (*i.e.*, for rollover purposes), or in the case of a matured RRSP or an RRIF, the spouse or common-law partner becomes the successor owner, in which case the income inclusion is transferred from the deceased owner to the recipient beneficiary or successor owner.

Any post-death increase in the plan or fund value, such as any income earned after the owner's death, is included in the income of the recipient designated beneficiary or, where there is no beneficiary designation, the deceased owner's estate.

## 2. Non-Resident Withholding Tax on Registered Plan Payments

Subsection 212(1) of the *Income Tax Act* requires that when a Canadian resident pays or credits an amount to a non-resident of Canada, the Canadian payor is to withhold the Part XIII tax, at a rate of 25% (unless reduced by an income tax treaty that Canada may have with the jurisdiction in which the recipient resides), from certain types of Canadian-source income.

While subsec. 212(1) specifically includes payments made to non-residents from RRSPs and RRIFs, the relevant legislative wordings need to be read carefully. With respect to the RRSPs, para. 212(1)(l) provides as follows:

> *Registered retirement savings plan payments*
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> (l) a payment out of or under a registered retirement savings plan . . . that would, if the non-resident person had been resident in Canada throughout the taxation year in which the payment was made, be required . . . to be included in computing the income of the non-resident person for the year, other than the portion thereof that
>
> (i) has been transferred by the payer on behalf of the non-resident person pursuant to an authorization in prescribed form
>
> (A) to a registered retirement savings plan under which the non-resident person is the annuitant . . .
>
> (B) to acquire an annuity described in subparagraph 60(l)(ii) under which the non-resident person is the annuitant, or
>
> (C) to a carrier . . . as consideration for a registered retire-

> ment income fund under which the non-resident person is the annuitant . . . , and
>
> (ii) would, if the non-resident person had been resident in Canada throughout the year, be deductible in computing the income of the non-resident person for the year by virtue of paragraph 60(l) . . .

Paragraph 212(1)(q) replicates the exact same wording for the RRIFs.

In other words, Part XIII tax is payable only where a payment made out of an RRSP or an RRIF to a non-resident would, if such non-resident were a resident of Canada, be included in his or her income for the year of receipt and be taxable to him or her. Therefore, only the portion of the payment which is actually taxable against the non-resident beneficiary would be subject to such withholding tax requirement. Conversely, no Part XIII tax is imposed on the portion of the payment to the non-resident beneficiary that is included in the income of the deceased owner.

Since, as a general rule, the date-of-death value of an RRSP or an RRIF is taxable to the deceased owner and not included in the income of the recipient beneficiary, no Part XIII tax is payable by the non-resident beneficiary with respect to such value. Therefore, the issuing financial institution is not required, or justified, to withhold such tax on the payment of the plan or fund proceeds. Where there is any income earned in the RRSP or RRIF after the owner's death, however, such increased amount is included in the income of the recipient beneficiary and thus would be subject to non-resident withholding tax.

Paragraphs 212(1)(l) and 212(1)(q) further contemplate that the proceeds of an RRSP or an RRIF can generally be rolled-over to the deceased owner's non-resident spouse or common-law partner, thereby shifting and then deferring the tax liability for the proceeds, without being subject to Part XIII tax. This is if, *inter alia*: (1) the proceeds are directly transferred to the recipient's RRSP or RRIF pursuant to an authorization in prescribed form; (2) such transfer would have been deductible from the income under the *Income Tax Act* if the spouse or common-law partner had been resident in Canada; and (3) such recipient has a valid Canadian social insurance number. Of course, future withdrawals by the non-resident spouse or common-law partner from his or her RRSP or RRIF would be subject to Part XIII tax.

In summary, there is no withholding tax on the payment of registered plan proceeds to a beneficiary under the *Income Tax Act*. Further, this is no different where the proceeds are paid out to a non-resident beneficiary as long as such amount is included in the deceased owner's income and there is no post-death increase in the plan value. To impose the Part XIII tax withholding requirement on the date-of-death plan value on the sole basis of the recipient beneficiary's non-residency is not only a misapplication of the *Income Tax Act*, but also an improper imposition of double taxation vis-à-vis the plan proceeds.

## II. U.S. TAXATION OF BENEFITS IN CANADIAN REGISTERED RETIREMENT PLANS

Canada has instituted a system of registered tax-deferred retirement plans, including RRSPs and RRIFs, which allow Canadians to save for retirement by setting aside their income on a tax-favoured basis. Unfortunately, the U.S. *Internal Revenue Code*[2] ("Code") does not treat foreign retirement savings plans favourably unless they satisfy the complex tax qualification rules of the Code. Absent a tax treaty, non-qualified foreign plans are treated as disqualified plans, subjecting participants to taxation when benefits are substantially vested.

The U.S.-Canada Tax Treaty[3] ("Treaty") avoids this adverse U.S. tax treatment of benefits accrued in non-qualified Canadian registered retirement plans. The Treaty applies to individuals who are taxable under the United States' regime of worldwide taxation on the basis of domicile, residence, or U.S. citizenship. Under Article XVIII of the Treaty, pensions and annuities paid to a U.S. resident are not taxed if the amounts would be excluded from taxable income in Canada if paid to a Canadian resident. This result applies broadly to RRSPs, RRIFs, employer-provided pension plans, and government and military pensions. Pursuant to the Treaty, an individual who is a resident of the United States may defer taxation of benefits under Canadian registered retirement plans until the benefits are distributed. Moreover, under Internal Revenue Procedure 2014-55, U.S. residents are deemed to have automatically elected to

2. U.S. Code Title 26.
3. *Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital*, Can. T.S. 1984/15.1.

defer taxation on income earned under such Canadian registered retirement plans.

Distributions from Canadian registered retirement plans are subject to U.S. taxation under Code § 72(w) when received. U.S. residents do not receive a basis in pre-residency contributions to Canadian registered retirement plans, nor are earnings exempt from taxation unless previously subject to U.S. or Canadian taxation. Canada may also tax distributions from Canadian registered retirement plans that are subject to U.S. taxation upon distribution. However, if the distributee is a U.S. resident and the distribution is a periodic pension payment, Canadian tax is capped at 15% of the gross distribution amount.

In summary, the Treaty avoids the acceleration of the timing of U.S. taxation of benefits under Canadian registered retirement plans. Distributions are subject to U.S. taxation when received, and the taxation of earnings is automatically deferred to coincide with the timing of the distribution. The gross amount of the distribution is subject to U.S. and Canada taxation and the participant is not considered to have any basis in pre-residency contributions or earnings to Canadian registered retirement plans.

## III. U.S. TAXATION OF NON-RESIDENT ALIENS WITH BENEFITS UNDER U.S. RETIREMENT PLANS

The U.S. income taxation of distributions to a non-resident alien of the United States (*i.e.*, an individual who is neither a citizen nor a resident of the United States) from a U.S. tax-qualified retirement plan depends on whether the amounts distributed are effectively connected with a U.S. trade or business, are otherwise attributable to U.S. sources, or are neither effectively connected with a U.S. trade or business nor attributable to U.S. sources. In the latter case, the U.S. tax consequences are simple: any amount distributed is not subject to U.S. income tax.

With a limited exception under Code § 864(b)(1) for non-resident aliens who are temporarily present in the United States for periods not exceeding 90 days in a taxable year and whose gross income attributable to those services does not exceed US$3,000, non-resident aliens who perform services in the United States are considered to have engaged in a U.S. trade or business. As a result, any income that is derived from those services represents income that is effectively connected with a U.S. trade or business. In general, any benefits that arise from U.S. services rendered by a non-resident alien retain their character as U.S. effectively connected income even if the individual is not performing services in the United States in the year the benefits are distributed; however, any benefits that were earned prior to 1987 are treated as U.S. effectively connected income only if the individual performs services in the United States at any time in the year the benefits are distributed. Any retirement distributions that are treated as being U.S. effectively connected income are generally taxed at the progressive tax rates generally applicable to U.S. citizens and resident aliens.

Although a rare fact-pattern, assume a non-resident alien individual never resided or performed services in the United States, but nonetheless accrued a benefit under a U.S. retirement plan. While any contribution to the plan on that individual's behalf would not be subject to U.S. income tax, any appreciation, dividends, or other income on the amounts contributed would represent income from U.S. sources. For example, assume that a foreign employee works for a U.S. employer solely outside the United States. The U.S. employer maintains a defined contribution profit-sharing plan, to which it has made contributions equal to US$100,000 on behalf of the foreign employee. At the time foreign employee receives a lump sum distribution from the plan, his or her account balance is equal to US$175,000. Since the foreign employee has never worked in the United States, no portion of the distribution is considered U.S. effectively connected income. Still, US$75,000 of the total US$175,000 lump sum distribution (representing the earnings on the US$100,000 in contributions made on the foreign employee's behalf) constitutes U.S.-source income. Any distribution that includes U.S.-source income that is not U.S. effectively connected income is generally subject to flat rate income taxation at 30%.

Code § 871(f) includes an important exception to a distribution from a qualified retirement plan constituting U.S. effectively connected income or U.S.-source income. Three requirements must be met for the § 871(f) exclusion from gross income to apply. First, the distribution must be paid as an annuity, meaning a lump sum distribution would not qualify. Second, except for services described in Code § 864(b)(1) (see above), the annuity benefit must be solely attributable to a non-resident alien's performance of services outside of the United

States. Third, at the time the annuity is first paid from the qualified plan, 90% or more of the employees for whom benefits are provided must be U.S. individual taxpayers (*i.e.*, U.S. citizens or residents).

In addition to the exclusion from U.S. gross income under Code § 871(f), the taxation of U.S.-source income may be modified by applicable tax treaty provisions. The Treaty provides that the United States may tax Canadian residents on U.S.-based pension income. However, if the distribution represents a periodic pension to a Canadian resident, section 2(a) of Article XVIII of the Treaty provides that the United States may not impose tax in excess of 15% of the gross amount of the pension distribution. Section 3 of Article XVIII of the Treaty defines "pension" as including any payment under, among other arrangements, any superannuation, pension, or retirement plan. With certain exceptions, the Internal Revenue Service's position is generally that a pension refers to payments that are contingent upon retirement. Importantly, section 2(a) of Article XVIII of the Treaty does not apply to all pension distributions, but only to periodic pension distributions. As a result, the Internal Revenue Service's general position is that a lump sum distribution would not come within the provision. Still, a lump sum distribution may constitute other income governed by Article XXII of the treaty, in which case the maximum tax the United States could impose on a lump sum distribution to a Canadian resident would be 15% of the amount distributed. See Internal Revenue Service Private Letter Ruling 9537028.