

Rollovers of US retirement plans to Canadian RRSPs or RRIFs

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From time to time, we come across clients who have US retirement accounts, having worked in the US for a number of years before moving back to Canada. A common question asked is whether such accounts can be transferred to Canadian RRSPs or RRIFs on a tax-free (or at least tax-deferred) basis.

There is no direct "tax-free transfer"; however, it may be possible to withdraw funds from a US retirement plan, contribute up to an equal amount to a Canadian retirement plan, and claim a deduction to reduce or eliminate the Canadian tax that would otherwise be payable on the withdrawn amount. Provided the client earned enough income in the year of transfer, they may in turn claim the US tax liability as a credit against the Canadian tax payable on their other sources of income, thereby preserving the tax deferral until retirement.

This article provides a general overview of considerations for Canadians with US retirement plans. The rules are complex and clients should seek the advice of their tax advisers prior to proceeding.

401(k) plans

A 401(k) plan is a US employer-sponsored pension plan that is typically funded by both employer and employee contributions. Contributions to these plans are deductible from pre-tax income and the funds grow tax-free until withdrawn. Generally, individuals must start withdrawals by April 1 following the later of: the calendar year in which they reach age 73 (75 for those born on January 1, 1960 or later), or retire (if their plan allows this). Subsequent distributions must be taken no later than December 31 of each calendar year. A Canadian plan that has similar features to a 401(k) plan is a defined contribution registered pension plan.

Traditional Individual Retirement Accounts (IRAs)

Traditional IRAs are similar to Canadian RRSPs in that they are personal savings plans that allow employees to make tax-deductible contributions to the account. There is no maximum age for making a contribution to an IRA. Individuals must generally start withdrawals by April 1 of the year following the calendar year in which they reach age 73 (75 for those born on January 1, 1960 or later). Required minimum distributions for subsequent years must be taken no later than December 31 of each calendar year. The earnings as well as contributions are tax-deferred until withdrawn. Just like Canadian RRSPs, traditional IRAs can be established at many different US financial institutions, including banks, insurance companies, and brokerage firms.

Roth Individual Retirement Accounts (Roth IRAs)

A Roth IRA is similar to the Tax Free Savings Account (TFSA). While contributions to a Roth IRA are not tax deductible, distributions (including earnings) from a Roth IRA are not included in income when withdrawn.¹ Roth IRAs can be set up at the same types of financial institutions as traditional IRAs.

Transfer from a Roth IRA to an RRSP or RRIF

Although the analysis of the tax treatment of Roth IRAs in Canada is complex and beyond the scope of this article, the general consensus is that money paid from a Roth IRA will not be taxable in Canada.² As a result, there would be no benefit (and in fact, it would be a disadvantage) to transfer a Roth IRA to an RRSP or RRIF, even if permitted.

Transfers from a 401(k) plan to an RRSP or RRIF

The Canada Revenue Agency takes the position that most 401(k) plans qualify as foreign pension plans and, as a result, the gross amount, before any US non-resident withholding taxes, distributed to a Canadian resident is fully taxable in Canada.

This income inclusion can be offset by a deduction to the extent that the amounts received from the 401(k) plan are contributed to an individual's RRSP within 60 days after the end of the year (which is the normal RRSP deadline), or to a RRIF. This deduction is only available if certain conditions are met.

First, the amount received from the 401(k) plan must be a lump-sum amount and not part of a series of periodic payments. It must also be attributable to services rendered by the individual (or his or her spouse or common-law partner) during a period while the individual was a non-resident. Finally, the amount transferred to an RRSP must be specifically designated as a transfer on Schedule 7 of the personal income tax return for the year of transfer.

401(k) plan owners should note that withdrawals that are made before the age of 59½ are subject to a 10% penalty tax in the United States. This additional tax may be claimed as a foreign tax credit in Canada.

¹ If certain requirements (such as a 5-year holding period) are met. In addition, a one-time election also needs to be made on the individual's Canadian tax return to have the treaty benefits apply.

² Provided there have been no contributions made to the IRA while you are a Canadian resident and the distribution is otherwise exempt from US taxation.

Transfer from an IRA to an RRSP or RRIF

An IRA is considered under Canadian tax law to be a "foreign retirement arrangement." As a result, the gross amount paid out of an IRA is also fully taxable in Canada in the year of receipt.

If, depending on the circumstances, the amount withdrawn from the IRA qualifies as an "eligible amount", this income inclusion can be offset by a deduction provided that the amounts received from the IRA are contributed to an individual's RRSP within 60 days after the end of the year, or to a RRIF. Such contributions must be specifically designated as a transfer on Schedule 7 of the personal income tax return for the year of transfer.

Again, withdrawals that are made before the age of 59½ are subject to a 10% penalty tax in the United States. This additional tax may be claimed as a foreign tax credit in Canada.

What is an "eligible amount" for purposes of this transfer? The amount must be included in income, received as a lump-sum payment and not as part of a series of periodic payments, and must have originated from contributions made to the plan by either the individual or the individual's spouse or partner, not his or her employer, during a period while the individual was a non-resident.

Is it worth it?

Under the right conditions, an IRA or 401(k) plan transfer to an RRSP makes sense, and may even be accomplished on a tax-neutral basis.

At best, if you are in a high enough tax bracket or if the balance in your 401(k) or IRA is low, the withdrawal of your US IRA or 401(k) and subsequent contribution to your RRSP will result in a zero net tax liability once all eligible foreign tax credits are claimed³, and the assets will thereafter sit happily in your RRSP or RRIF in Canada (assuming you have enough cash to re-contribute to your RRSP or RRIF what the IRS has previously withheld).

While that sounds appealing, at worst, if done for someone in a low tax bracket, with a sizeable 401(k) or IRA account balance, or if processed incorrectly, very little, if any, of the US tax liability will be recovered when filing in Canada – meaning that some of your 401(k) or IRA balance will be subject to double taxation.

In practice, such transfer can be truly worth-while, but it is imperative to plan ahead. It is strongly recommended to obtain proper counsel from a cross border tax advisor before attempting a transfer from any foreign pension to assess whether the transfer will deliver the sought-after results.

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³ Provided you earned sufficient income from other sources in the year of transfer.

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