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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Taxation of a registered education savings plan (RESP) for U.S. persons

Understanding the U.S. tax implications

An RESP is a tax-deferred savings plan that allows the subscriber to save for a beneficiary's post-secondary education. U.S. persons who are a subscriber or contributor to an RESP or a beneficiary of an RESP may be subject to U.S. tax and U.S. filing requirements. This article summarizes the U.S. tax implications (including U.S. income tax and U.S. transfer tax) that may apply when a U.S. person is involved with an RESP.

This article is intended for U.S. citizens and other persons considered to be U.S. residents for U.S. income tax and U.S. transfer tax purposes who reside in Canada. The information provided is based on U.S. federal tax and the Canada-U.S. income tax treaty (Treaty). For U.S. tax purposes, a spouse refers to a person to whom you are legally married (it doesn't generally include a common-law partner). Therefore, any reference to a spouse in this article refers to a legally married individual only. This article also assumes you have a basic understanding of the Canadian tax planning benefits of a RESP. If you would like further information on establishing and withdrawing from an RESP, please ask your RBC advisor for a separate article.



Overview of the U.S. tax system

Foreign trust rules

The U.S. income tax system includes complex non-U.S. trust rules (referred to as the U.S. foreign trust rules). A detailed discussion of the U.S. foreign trust rules and filing requirements is beyond the scope of this article. However, as a general overview, these rules may affect U.S. persons who are involved with a non-U.S. trust (a foreign trust). The tax implications to a U.S. person who has an interest or involvement with a foreign trust depends on whether the foreign trust is classified as a foreign grantor or foreign non-grantor trust, as well as the person's role in the trust (i.e. owner, contributor or beneficiary). An RESP that is set up in Canada as a trust may be treated as a foreign trust for U.S. income tax purposes. In this article, it's assumed this is the case.

U.S. transfer tax

The U.S. transfer tax system consists of a U.S. gift tax, U.S. estate tax and U.S. generation skipping transfer tax (GSTT). The U.S. transfer tax system is discussed in greater detail in a separate article that you may obtain from your RBC advisor. However, as a general overview, U.S. gift tax may apply to gifts made during your lifetime and U.S. estate tax may apply to the fair market value (FMV) of property you own upon your death. GSTT imposes another layer of gift or estate tax if you make a taxable gift or bequest to a "skip person" such as a grandchild or great-grandchild.

U.S. tax treatment

It's important to seek advice from a qualified cross-border tax advisor about whether you should be a subscriber or contributor of an RESP. In particular, you'll want to consider the after-tax return of investing in this plan, which should take into account both the Canadian and U.S. tax implications and any additional U.S. tax preparation fees you may incur related to the RESP.

Ideally, a U.S. person should not be the subscriber of an RESP nor a contributor to an RESP where the RESP will qualify as a foreign grantor trust, due to the risk of double taxation of the income earned in the RESP and the government grant, as well as the bond paid into the plan.

The U.S. tax implications to a U.S. beneficiary depends on whether the RESP is considered a foreign grantor trust or a foreign non-grantor trust. These concepts are discussed further below.

U.S. subscriber

A U.S. person who's a subscriber of an RESP is treated as an owner of a foreign grantor trust for U.S. tax purposes because they may generally reclaim contributions made

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to the RESP. This is also the case where the subscriber isn't a U.S. person. However, a subscriber who is a U.S. person is subject to U.S. income tax annually on:

- Income and realized capital gains earned on your contributions to the RESP
- Government grant and bond amounts paid into the plan as a result of those contributions, and
- Income and realized capital gains earned in the plan on the grants and bonds.

When these amounts are eventually distributed to beneficiary or contributions are refunded to you, you are not subject to further U.S. income tax.

You may also be subject to tax on income and capital gains earned on contributions made to the RESP by a third party, as well as grants paid into the plan as a result of these contributions and income and realized capital gains earned on the grants. (See discussion related to third-party contributor in the next section for more information.)

Unfortunately, the Treaty doesn't provide any relief where the subscriber of an RESP is a U.S. person. Also, if you hold investments that are considered passive foreign investment companies (PFICs) in the plan, such as Canadian mutual funds and ETFs, you may be subject to the PFIC rules. If you would like more information on the PFIC rules, please ask your RBC advisor for a separate article on this topic.

U.S. gift tax implications for a U.S. subscriber

Contributions you make to an RESP are not subject to U.S. gift tax since they are incomplete gifts (you can receive a refund of contributions). However, gift tax would apply when distributions from the RESP are directed to the beneficiary of the plan (unless you are the beneficiary), assuming you are still a U.S. person at the time of distribution. The distribution would be considered a taxable gift to the extent it exceeds the available gift tax annual exclusion amount.

Subscriber's death

If you're a U.S. subscriber to an RESP, you may be subject to U.S. estate tax on the FMV of the property in the plan on your death.

Where a subscriber passes away and a successor subscriber is named, subject to the terms and conditions of the RESP, the successor subscriber may have the same rights as the previous subscriber. This may include the ability to take out the contributions made to the plan by the deceased subscriber and any third-party contributors. If this is the case, and the successor subscriber is a U.S. person, the RESP may continue to qualify as a foreign grantor trust for the successor subscriber, not only with respect to new contributions made to the plan but also with respect to the contributions made by the deceased subscriber. The tax implications discussed earlier for a U.S. subscriber will apply to the successor subscriber going forward.

If the successor subscriber isn't a U.S. person, even if they are the spouse, the plan may be reclassified as a foreign non-grantor trust with respect to the deceased subscriber's contributions. Similarly, if a successor subscriber doesn't immediately take over the plan, the RESP may also be treated as a foreign non-grantor trust for its U.S. beneficiaries in respect of the contributions made by the deceased subscriber. Where the RESP is reclassified as a foreign non-grantor trust after the death of the subscriber, a U.S. beneficiary may be subject to the throwback rules (discussed earlier) on distributions that include income and capital gains earned on the property in the plan since the date of the subscriber's death.

Third-party contributor

A third-party contributor to an RESP who is a U.S. person (a U.S. contributor) may be treated as an owner of a foreign grantor trust with respect to their contributions to the RESP if they are the beneficiary of the RESP, their spouse is a beneficiary of the RESP, or another U.S. person is a beneficiary of the RESP. Where the trust is a foreign grantor trust, the U.S. contributor is generally subject to the same tax treatment that applies to a U.S. subscriber of an RESP.

If a third-party contributor isn't a U.S. person and they are unable to receive a refund of contributions, the contributor will not be considered the owner of a foreign grantor trust with respect to their contributions, regardless of whether their spouse is a beneficiary of the RESP or another U.S. person is a beneficiary of the RESP. In this case, if the subscriber of the plan is a U.S. person, the U.S. subscriber will generally be treated as the owner of the plan and subject to the same foreign grantor trust tax treatment as discussed earlier. However, if the subscriber isn't a U.S. person, the RESP will qualify as a foreign non-grantor trust with respect to the third-party contributor's contributions and the throwback rules may apply to a U.S. beneficiary. (See discussion related to foreign non-grantor trust and the throwback rules in the next section for more information.)

If the successor subscriber isn't a U.S. person, even if they are the spouse, the plan may be reclassified as a foreign non-grantor trust with respect to the deceased subscriber's contributions. Similarly, if a successor subscriber doesn't immediately take over the plan, the RESP may also be treated as a foreign non-grantor trust for its U.S. beneficiaries in respect of the contributions made by the deceased subscriber.

It's important to note that each financial institution may have their own policies relating to third-party contributions. Check with your financial institution to determine if there are any restrictions with respect to contributions made by a third-party.

Foreign non-grantor trust and the throwback rules

When a U.S. beneficiary receives a distribution from an RESP that is treated as a foreign non-grantor trust, they may be subject to punitive U.S. tax rules (known as the throwback rules) with respect to the portion of the distribution that represents income that has accumulated in the plan and was not paid out in the year it was earned. The portion of the distribution that represents accumulated income would generally include income and realized capital gains earned on the contributions, government grants and bonds paid into the plan, and income and realized capital gains earned on those grants and bonds.

When accumulated income is paid to a U.S. beneficiary, it's taxed as ordinary income and an interest charge is also applied based on the tax on the accumulated income. While a U.S. beneficiary may be able to claim a foreign tax credit on their U.S. income tax return for any Canadian income tax paid on the RESP distribution, it may not completely offset their U.S. tax liability.

U.S. gift tax implications for a U.S. contributor

A U.S. third-party contributor to an RESP who isn't a subscriber may be subject to U.S. gift tax on contributions made to the RESP to the extent they exceed the available gift tax annual exclusion.

Third-party contributor's death

If you're a third-party U.S. contributor, you're generally not subject to U.S. estate tax on the FMV of the property in the RESP on your death unless you're able to determine who receives the funds contributed to the RESP or are able to receive a refund of the contributions.

When a third-party contributor of the RESP that is a foreign grantor trust passes away, the RESP may be reclassified as a foreign non-grantor trust with respect to their contributions. This would occur where the subscriber isn't a U.S. person or if the subscriber is a U.S. person, where they don't have the ability to take out the contributions made to the plan by a third-party contributor. A U.S. beneficiary may be subject to the throwback rules when they receive a distribution of income or capital gains earned on the third-party's contributions after their death.

U.S. beneficiary

Where the RESP is a foreign grantor trust in respect of the subscriber and/or contributor, the U.S. beneficiary isn't subject to U.S. income tax when they receive a distribution from the RESP, provided the necessary U.S. tax filings are made. If the required U.S. tax forms are not properly filed, the distribution may be subject to the punitive throwback rules discussed earlier. Your U.S. beneficiary should speak to a qualified cross-border tax advisor to determine what filings must be provided to ensure distributions are tax-free to them.

Double taxation

There is the potential for double taxation due to differences in the Canadian and U.S. tax treatment of an RESP. For Canadian tax purposes, income and capital gains earned in the RESP will generally not be taxable until the year in which it's distributed to a beneficiary (as an educational assistance payment), or under certain circumstances, to the subscriber (as an accumulated income payment). At that time, the income and capital gains will be taxable in the beneficiary's or subscriber's hands. For U.S. tax purposes, however, a U.S. subscriber or contributor may be subject to tax annually under the foreign grantor trust rules. Foreign tax credit relief isn't available where different taxpayers are subject to Canadian and U.S. taxation or when tax liability are incurred in different tax years. As a result, there may be double taxation.

If you're currently a subscriber to an RESP, you may wish to consider whether it would make sense to replace yourself with a non-U.S. subscriber to minimize any U.S. tax issues. You should speak to a qualified tax advisor to determine the steps you may need to take to change the subscriber of the plan. From a U.S. tax perspective, if the beneficiaries are U.S. persons or your spouse, the RESP will continue to be a foreign grantor trust and you will continue to be subject to tax on the income and capital gains earned in the plan as well as on any grants and bonds paid into the plan.

If the beneficiaries of the RESP aren't U.S. persons or your spouse, then provided you name someone who isn't a U.S. person and someone other than your spouse as

Where the RESP is a foreign grantor trust in respect of the subscriber and/or contributor, the U.S. beneficiary isn't subject to U.S. income tax when they receive a distribution from the RESP, provided the necessary U.S. tax filings are made.

a replacement subscriber, you will no longer be subject to U.S. income tax on the income and capital gains earned in the RESP. This will, however, change the trust's classification from a foreign grantor trust to a foreign non-grantor trust, and will result in a deemed disposition for U.S. tax purposes of the assets held in the trust related to the contributions you made and the grants and bonds in the plan while you were the grantor. The net capital gains will be taxable to you as the U.S. grantor on your U.S. tax return.

You may be subject to U.S. gift tax as a result of transferring your interest in the plan to a new subscriber. However, once you replace yourself as subscriber of the RESP, you will not be subject to U.S. estate tax on the property in the RESP on your death, unless you pass away within three years of the date of replacement.

Before removing and replacing yourself as subscriber, it's important to consider that you may no longer have access to the contributions made to the plan. Depending on the terms of the RESP, if your contributions are not used by the beneficiary, the new subscriber can generally receive a refund of the remaining contributions.

Summary

There are many considerations you need to take into account when saving for education with an RESP. As a U.S. person living in Canada, the U.S. tax laws and their implications to the RESP must be considered before you set up and/or contribute to an RESP to prevent punitive U.S. tax implications. Speak to a qualified cross-border tax professional for advice before you set up and/or contribute to an RESP.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.



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