THE NAVIGATOR

TRANSFERRING A FOREIGN-BASED RETIREMENT PLAN TO AN RRSP

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A tax-deferred strategy worth considering if you are retiring in Canada

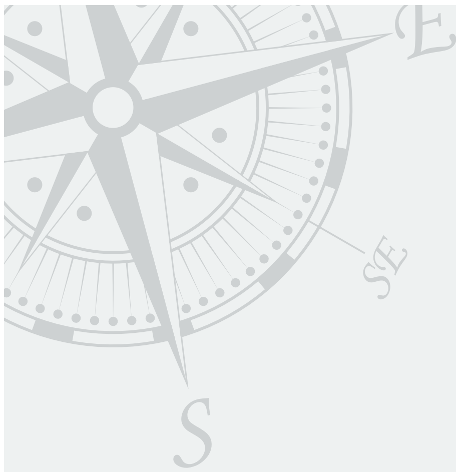
If you spent time working in a foreign country you may have accumulated funds in a foreign-based retirement plan. For example, if you worked in the United States (U.S.), you may have participated in a 401(k) or 403(b)plan, contributed to a traditional Individual Retirement Account (IRA), or another U.S-based retirement plan. If you are settling in Canada you may be wondering whether you can consolidate your foreign-based retirement plan with your Canadian-based retirement accounts.

Under certain conditions, Canadian tax rules allow residents of Canada to contribute benefits withdrawn from certain foreign-based retirement plans to a Registered Retirement Savings Plan (RRSP) without using RRSP contribution room. It may be possible to transfer these plans on a tax deferred basis by claiming foreign tax credits on your Canadian income tax return to recoup foreign taxes resulting from the withdrawal.

The tax rules and considerations regarding moving foreign-based retirement plan assets to an RRSP can be fairly complex. Bear in mind, the ability to contribute amounts withdrawn from a foreign-based retirement plan to your RRSP under Canadian tax rules does not create an obligation for a foreign plan administrator to release funds to you or prevent them from imposing other restrictions.

This article is for information purposes only and does not provide tax or legal advice. It will discuss transferring a foreign-based retirement plan to an RRSP with an example of transferring certain U.S.-based retirement plans on a tax deferred basis. Although the process for transferring U.S-based retirement plans may be similar for other foreign-based retirement plans, it is essential that you seek the advice of a tax professional that is familiar with the strategy and the foreign country's tax and pension laws before taking any action on the information provided in this article.

RBC Wealth Management



The Canadian Income Tax Act *(Act)* contains "special provisions" that allow you to contribute benefits withdrawn from certain types of foreign-based retirement plans to your RRSP.

Eligibility to Transfer Foreign-Based Retirement Plan Assets to Your RRSP

The Canadian Income Tax Act *(Act)* contains "special provisions" that allow you to contribute benefits withdrawn from certain types of foreign-based retirement plans to your RRSP, including foreign pension plans (e.g. a U.S. 401(k) or 403(b) plan) or foreign retirement arrangements (e.g. U.S. traditional IRA), without using or requiring RRSP contribution room provided certain conditions are met.

When determining whether benefits withdrawn from a foreign-based retirement plan (including a U.S. 401(k) or IRA plan) will qualify under the special provisions you should consider the following:

- The contribution to your RRSP must take place by December 31 of the calendar year in which you turn 71.
- You must be a resident of Canada at the time of the contribution to your RRSP.
- The withdrawal from the foreign-based retirement plan must be received as a lump sum payment.
- If you are withdrawing a benefit from a foreign pension plan (such as a 401(k) plan) the gross amount of the benefit withdrawn may be contributed to your RRSP under the special provisions provided the contributions to the plan relate to services rendered while you were a non-resident of Canada. For example, if you became a non-resident of Canada to work in the U.S. benefits related to both the employee and employer contributions to the 401(k) plan may be withdrawn and contributed to your RRSP under the special provisions. Where such a 401(k) plan has been transferred to a traditional IRA ask your tax advisor about qualifying under the special provisions before making the withdrawal.
- If you or your employer made contributions to a 401(k) for services rendered in a period when you were a resident of Canada, for example, you lived near the border and commuted to the U.S. to work on a daily basis, the plan will not qualify under the special provisions. Ask your tax advisor about qualifying under the special provisions if you transfer the 401(k) assets to a traditional IRA before making the withdrawal.
- If you are withdrawing a benefit from a foreign retirement arrangement such as a U.S. traditional IRA, only benefits related to contributions that were made to the plan by you, your spouse, or your former spouse will qualify for the transfer permitted under the special provisions. For example, if you and your employer funded a traditional IRA the benefits withdrawn related to your contributions may qualify under the special provisions however benefits related to your employer's contributions will not. Although most IRAs are funded solely by the plan holder, certain company-sponsored IRAs include contributions made directly to the plan by an employer.
- If you inherited a foreign-based retirement plan from someone other than your spouse, a lump sum withdrawal will not qualify for contribution to your RRSP under the special provisions without using RRSP contribution room.

Roth IRAs are not considered to be foreign pension plans nor foreign retirement arrangements so you cannot contribute lump sum withdrawals from this plan to your RRSP without using RRSP contribution room.

- Roth IRAs are not considered to be foreign pension plans nor foreign retirement arrangements so withdrawals from these plans do not qualify under the special provisions. Therefore, you cannot contribute lump sum withdrawals from this plan to your RRSP without using RRSP contribution room.

Even if you determine for Canadian tax purposes that the foreign-based retirement plan benefits withdrawn may be transferred to an RRSP under the special provisions, you must also look at any guidelines or restrictions imposed by the foreign country. Depending on the foreign country, there may be restrictions on your ability to withdrawn benefits or restrictions that dictate how the funds must be invested. Therefore, you should confirm with the foreign-based retirement plan administrator and your tax advisor whether any restrictions would prevent you from contributing the benefits to your RRSP.

Basic Process for Transferring a U.S.-Based Retirement Plan to an RRSP

Once you and your tax advisor have determined that this strategy makes sense for you, that the foreign-based retirement plan qualifies under the special provisions and there are no restrictions imposed by the foreign country, you may execute the transfer. The following illustrates the general steps for contributing benefits withdrawn from a U.S.-based retirement plan to an RRSP with the corresponding Canadian and U.S. tax reporting requirements. A similar process may apply to withdrawals from other foreign-based retirement plans; however, you should confirm the process with your tax advisor:

Step 1: Make a lump sum withdrawal from your foreign-based retirement plan and pay any foreign income tax.

Instruct your U.S. plan administrator to collapse your qualifying U.S. plan and mail a cheque of the proceeds to you. You will receive proceeds net of U.S. withholding tax.

If you are a U.S. citizen/green-card holder the withdrawal may be subject to U.S. withholding tax of 10-20%. The withdrawal must be reported on a U.S. resident income tax return (Form 1040) and is subject to U.S. tax at graduated tax rates.

A lump sum withdrawal by a Canadian (non-U.S. citizen/green-card holder) is subject to a 30% U.S. nonresident withholding tax rate, although some U.S. plan administrators may withhold a lower rate. If the benefits withdrawn relate to employment services performed in the U.S., the withdrawal may be considered to be income "effectively connected with a U.S. trade or business". This may require you to report the gross amount of the withdrawal on a U.S. nonresident income tax return (Form 1040NR), subjecting the withdrawal to tax at graduated U.S. tax rates. You should confirm the U.S. filing requirements with your tax advisor.

The U.S. income tax liability on the tax return will be reduced by the amount of U.S. tax that was withheld at source. You may receive a refund if the withholding tax is larger than the tax liability calculated on the tax return, or you may need to pay the difference. Where a U.S. tax return is required, irrespective of the initial amount of tax withheld when you made the withdrawal, your ultimate U.S. tax liability is the tax liability calculated on your U.S. 1040NR nonresident tax return.

If you are under age 59 ½ when the withdrawal is made you may be subject to a nonrefundable 10% early withdrawal penalty.

Note: If you are under age 59 ½ when the withdrawal is made you may be subject to a nonrefundable 10% early withdrawal penalty. The U.S. plan administrator is not responsible for withholding this early withdrawal penalty from the lump sum withdrawal. However, you will be required to file a U.S. 1040NR nonresident tax return to calculate and remit the penalty to the IRS. The penalty is reported on your U.S. tax return and is added to your total U.S. income tax liability.

Step 2: Contribute an amount equal to the gross value of the withdrawal that is permitted to be transferred to your RRSP under the special provisions.

Where the full amount of the benefit withdrawn may be contributed to your RRSP under the special provisions, the Canadian-dollar equivalent of the gross amount withdrawn (the full amount before withholding tax) may be contributed to your RRSP to take full advantage of this strategy. You must make this contribution by the end of the regular RRSP contribution deadline (during the year of the withdrawal, or 60 days after the end of that year, at the latest). You will receive an RRSP contribution receipt. You may also contribute benefits withdrawn that do not qualify under the special provisions provided you have sufficient RRSP contribution room.

Step 3: Report the withdrawal and RRSP contribution on your Canadian income tax return.

The gross withdrawal from your U.S. plan (converted into Canadian dollars using the foreign exchange rate in effect on the date of the withdrawal) should be reported as taxable income on your Canadian income tax return. In addition, the contribution to your RRSP should be reported as a deduction to offset the amount included in your taxable income. In order to indicate to the Canada Revenue Agency (CRA) that you are using special provisions to allow you to contribute an amount to your RRSP without using RRSP contribution room, you must report the RRSP contribution on line 14 of Schedule 7 on your Canadian tax return.

The amount of the withdrawal included on your Canadian tax return is considered U.S. source income. To recover your U.S. tax liability (including the 10% non-refundable penalty incurred) claim a foreign tax credit on your Canadian income tax return to reduce your ultimate Canadian tax liability by the U.S. income tax and penalty paid. In order to fully recoup the U.S. taxes paid, you must have sufficient Canadian income tax generated from other sources of income, such as salary, investment income and capital gains.

Consider These Points Before Collapsing Your Foreign-Based Retirement Plan

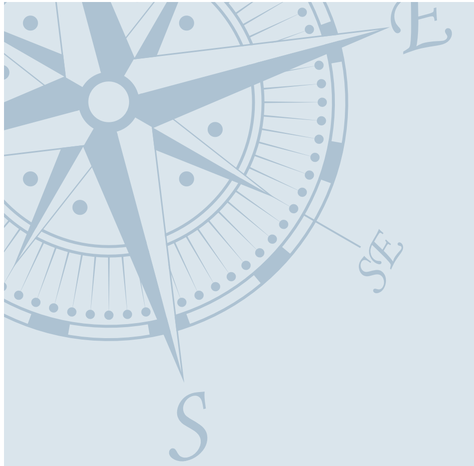
In addition to the considerations discussed earlier, the following additional items should be considered in deciding whether it makes sense to transfer a U.S. or other foreign-based retirement plan to your RRSP:

- The gross amount of the withdrawal from your foreign-based retirement plan will generally be taxable in Canada and in the foreign country. In addition, the foreign country may impose other penalties on the withdrawal (e.g. the U.S. imposes a 10% early withdrawal penalty). You

Ensuring that you have a strategy in place to allow you to claim a full foreign tax credit is a key issue that should be discussed with your professional tax advisor.

may be able to claim a foreign tax credit on your Canadian income tax return to recover the foreign tax and penalties incurred. However, the ability to claim a full foreign tax credit depends on the amount of foreign tax and penalties paid, your net income (apart from the foreign-based retirement plan income) reported on your Canadian tax return in the year of the withdrawal and the resulting Canadian income tax owing.

- Ensuring that you have a strategy in place to allow you to claim a full foreign tax credit is a key issue that should be discussed with your professional tax advisor. This is because you cannot claim a foreign tax credit in a future year on excess foreign tax incurred in the current year that you are unable to fully recoup. If you are not able to claim a full foreign tax credit, this could result in double taxation of the plan benefits (since the benefits may be taxed once by the foreign country and again in Canada when they are withdrawn from your RRSP).
- It may not be beneficial to make the withdrawal if you are unable to recover the foreign tax and penalty you may incur. In such cases, you may consider avoiding the 10% early withdrawal penalty for U.S.-based retirement plans by waiting to make withdraws until you reach the age of 59½; or, to claim a full foreign tax credit, you may consider whether it makes sense to trigger additional Canadian income by realizing accrued capital gains or making two lump sum withdrawals (one in each of the next two years). Speak to a professional tax advisor for advice.
- In certain cases, it may still be beneficial for Canadians to contribute their foreign-based retirement plan assets to an RRSP even if they cannot recoup all the foreign income tax and penalties incurred. This would be the case where you would incur a much larger estate or inheritance tax liability than the foreign taxes and penalties you were unable to recoup. For example, if a Canadian (non-U.S. citizen or green-card holder) that is terminally ill will incur a much larger U.S. estate tax liability than the foreign taxes and penalty they could not recoup they would still be better off making the withdrawal from the foreign-based retirement plan since their overall foreign tax liability would be minimized.
- Bear in mind, in order to offset the income inclusion resulting from the withdrawal from your foreign-based retirement plan that was subject to withholding tax, you will need to make an RRSP contribution equal to the gross value of the withdrawal. You will need to have access to funds equal to the amount of the foreign withholding tax to make a full RRSP contribution. For U.S.-based retirement plans, if you are required to file a U.S. income tax return, you may have an additional tax liability and penalties over and above the U.S. withholding tax on the initial withdrawal. A tax liability on your U.S. income tax return is due to be paid to the U.S. by April 15 of the following year – the U.S. tax return deadline. This may result in a short term cash flow issue until your Canadian tax return is filed and assessed. Therefore, you may wish to consider borrowing the funds if you do not have sufficient funds available to make the RRSP contribution for the gross amount



There are many potential benefits to consolidating your foreign-based retirement plans with an RRSP in Canada.

and to pay any additional foreign tax and penalties incurred. If you are able to recover the full foreign tax credit on your Canadian tax return, the borrowed funds will only be needed on a temporarily basis since you will receive a refund on your Canadian return and can repay the loan.

Benefits of Contributing Foreign-Based Retirement Plan Assets to Your RRSP

There are many potential benefits to consolidating your foreign-based retirement plans with an RRSP in Canada, particularly if you expect to be spending most of your time in Canada when you draw income from these plans. Some of the key benefits are as follows:

Simplify the Management of Your Retirement Portfolio and Income Sources

Ensuring that the overall asset allocation of your portfolio is on target, tax-planning opportunities are optimized, and that specific investment decisions are made and implemented in a timely manner are all easier tasks when your portfolio is held in as few accounts and financial institutions as possible.

Manage Your Exposure to Foreign Currency Risk

Funds withdrawn from your foreign-based retirement plan will be paid to you in the currency of that country. It may be very difficult, if not impossible, to predict if the Canadian currency will increase or decrease in value relative to that country's currency, particularly over a long period of time. While it is possible for you to benefit from fluctuating foreign exchange rates, it is also possible to suffer a loss in your purchasing power if exchange rates move in the opposite direction.

Contributing your foreign-based retirement plan assets to an RRSP will allow you to match the currency of your future income sources with the currency of your future expenses and avoid any foreign exchange risk that could potentially have a negative impact on your cash flow during retirement.

Reduce or Eliminate Your Exposure to Foreign Estate and Inheritance Tax

Owning assets in a foreign country may expose you to estate and inheritance taxes in that country. For example, many Canadians who own U.S. assets may be subject to U.S. estate tax at death – even if they are not a U.S. resident, citizen or green-card holder. For the purposes of U.S. estate tax, assets held in a U.S.-based retirement plan are considered to be situated within the U.S., regardless how the funds in the plan are invested. Assets held in an RRSP in Canada, on the other hand, are not considered situated in the U.S. for Canadians (with the exception of investments in certain U.S. securities).

You may be able to reduce or eliminate your exposure to U.S. estate tax or other foreign estate or inheritance tax regimes by transferring your foreign-based retirement plan to an RRSP in Canada. Ask your tax advisor to evaluate the benefits.

If you are a U.S. citizen or green-card holder residing in Canada there is no distinction between assets situated within the U.S. and those situated elsewhere for the purpose of calculating your exposure to U.S. estate tax. Therefore, transferring your U.S.-based retirement plan to an RRSP in Canada will not help you to reduce your exposure to U.S. estate tax.

> Transferring your foreign-based retirement plan to an RRSP in Canada may provide you with more choice and greater flexibility to adjust your investment holdings as your needs change.

Increase your Choice of Investment Options

Canadian financial institutions may offer a wider range of investment products that typically appeal to Canadian investors compared to what U.S. or other foreign-based financial institutions can offer to them.

In addition, Canadian provincial securities commissions may impose restrictions on the trading activities of non-resident investment advisors, including those based in the U.S. and other foreign countries. Depending on the type of plan that you hold, you may be restricted from requesting changes to the investments held in your foreign-based retirement plan.

Transferring your foreign-based retirement plan to an RRSP in Canada may provide you with more choice and greater flexibility to adjust your investment holdings as your needs change.

Obtain Local Service and Advice with a Canadian Perspective

Very few financial institutions outside Canada are able to provide advice regarding how their foreign-based retirement account fits in the context of a Canadian resident's overall retirement plan. Also, providing customized advice to you can be more challenging by telephone and e-mail.

For most residents of Canada, dealing with a local financial advisor who specializes in retirement planning for Canadians is generally preferable.

Where it is not possible or practical to transfer your foreign-based retirement plan to an RRSP in Canada, RBC is one of the few Canadian financial institutions to have advisors with Canadian retirement planning experience, in certain key locations within the U.S. and other parts of the world.

Conclusion

While there are many compelling reasons to transfer a U.S. or foreign-based retirement plan to an RRSP in Canada, there are many issues to consider and tax implications to be aware of before proceeding. Clearly, there is no one strategy that is right for everyone. It is essential to seek advice from a professional tax advisor who is experienced in these matters. In some cases, it may be best to simply leave the U.S. or other foreign-based retirement plan in place and receive an income stream from it when you retire.

Please contact us for more information about the topics discussed in this article.

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