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Capital Management

Transferring Your IRA or 401k to an RRSP

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When moving between Canada and the USA, there are common challenges that individuals often face. Aside from the practical aspects of the move, there are also tax and financial considerations to assess.

If you have accumulated savings in a 401k plan or an individual IRA (Individual Retirement Account), what should you do with these retirement plans if you move to Canada and what are some of the planning considerations?

There is no simple answer for the procedure but here are some tips and general information.

General Terms and Options

A 401k is an employer sponsored defined contribution (DC) retirement arrangement. It is similar to a Group RRSP in Canada, and the IRA could be likened to an RRSP. Both are considered "foreign retirement arrangements" by the CRA and are tax-sheltered in that earnings in the plan aren't taxed – but anything taken out of the plan is taxed as income.

If the plan contributions were made by your employer while you were a resident of the USA, you will be allowed to make a transfer of a lump-sum payment from your 401k to a rollover IRA (employer permitting) you can then transfer the IRA proceeds to a Canadian RRSP and potentially recoup the majority of the taxes paid on withdrawal.

Let's assume you are a **Canadian citizen (not a dual or US citizen)** and have contributed to a 401k or IRA while working for an employer in the USA. If you decide to move back home to Canada and become a non-resident alien for US tax purposes, what should you do with the 401k or IRA account? Your choices are typically to:

1) leave it in the USA and have someone manage the investments for you;
2) cash out the plan and pay taxes on the entire amount;
3) if you are of retirement age, begin taking distributions;
4) transfer or "rollover" the plan to an RRSP in Canada.

An added complexity for the above choices is that they are affected by tax implications and securities regulations.

Here are the most common scenarios we encounter:

Option 1: Leave 401k or IRA as-is

If you choose this option, you would essentially leave the plan intact until you require the income during retirement. This option may be the easiest route and would likely allow for the longest tax deferral, and potentially the largest tax deferral as well, considering that over the long-term, it would typically earn a positive rate of return.

Unless the manager of the 401k permits, you may be required to transfer the 401k to an IRA.

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If you are over the age of 59.5, you would typically see a 20% withholding tax on your lump sum distributions, reduced to 15% under the US/Canada tax treaty for non-resident aliens (meaning that you'd need to file the IRS W8-BEN Form).

Note: The 15% reduced withholding tax is referenced in the Canada-USA tax treaty for "periodic pension payments" and if your IRA custodian (the financial institution the account is held with) does not view the distribution as a periodic payment, they may apply a 30% withholding to what they view as a lump-sum distribution. It's important to clarify this with them at the start of this process.

If you are under the 59.5 years of age threshold, there would be an additional 10% penalty unless you meet certain conditions. There would likely be no tax payable on the earnings within the plan until you begin to make withdrawals.

On annuitized withdrawals, you'd pay 15% withholding tax to the IRS on the distributions and then apply a foreign tax credit for the same amount towards the same foreign pension income on your Canadian tax return.

Also note that the CRA maintains that you should file an election each year on your Canadian tax return to continue deferring taxes, which may be accomplished by sending them a letter with your tax information and IRA details.

Choosing to leave the plan as-is in the US may result in restrictions due to regulatory complications. Many investment firms and brokerages will not allow an investment account (retirement account or otherwise) to be held by a non-resident, or they may restrict trading to sales only (no purchases) and cease to offer any investment or planning advice.

In these cases, you may need to consider working with a cross-border investment manager.

Option 2: Cash Out the 401k or IRA

This is option is generally considered the least favorable as it would typically result in the largest immediate tax liability. There is no compelling reason why you should redeem your IRA and cash out the plan, unless you need the net cash amount for immediate purposes. It would result in all of the IRA proceeds being added to your net income for the year, and you would be taxed accordingly.

Note that if you are under age 59.5 there is an additional 10% penalty which may qualify for a foreign tax credit.

Option 3: Start taking retirement distributions

If you are over 59.5 years of age and need the funds for retirement, consider leaving the IRA intact and take annual distributions. It has been successfully argued that once you have "annuitized" your IRA (taking regular annual withdrawals) and with a W8-BEN you should receive a lower withholding tax of 15% on withdrawals which could be used as a foreign tax credit against Canadian income taxes.

Option 4: Transfer 401k or IRA to RRSP

Please discuss your personal tax situation with a qualified cross-border tax accountant before taking any action. The transfer of a 401k ultimately to an RRSP usually occurs as follows,

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and here we will use an example of someone with an IRA worth $100,000 USD:

1. Open a Rollover IRA account with your broker prior to leaving the USA or with an investment firm capable of Crossborder management. While we have seen that it is possible to make the withdrawal directly from the 401k, technically employer contributions are not eligible for the rollover, which is why many elect to first rollover to an IRA to effectively “hide” these amounts.

2. Rollover that 401k to the IRA while still a resident of the US. Note that you can rollover the 401k to an IRA after you move as well, but it may be more complicated as a non-resident – you may need a Crossborder advisor to do so. Note only pre-tax contributions can be moved to a Rollover IRA, whereas post-tax contributions may be moved into a Roth IRA.

3. Withdraw the IRA as a Canadian resident (you will be assessed up to 30% withholding tax, possibly reduced to 15%). If you are under 59.5 years, there may be an additional 10% penalty which might not be recoverable.

4. The net resulting lump sum payment ($85,000 for someone over 59.5) can be contributed to an RRSP as a 60(j) contribution. Ensure that the bank or brokerage for your RRSP knows this and they should ensure it is documented on your statement or your contribution receipt. The deposit into your RRSP must occur in the year of withdrawal or within 60 days of year-end. Determine the value of the transfer in Canadian dollars.

5. The full gross withdrawal (USD $100,000) including the withholding tax is included as Canadian taxable income. You would get an offsetting RRSP deduction from the net proceeds you contribute to the RRSP ($85,000) referencing the section 60(j) transfer.

6. If possible, you should top up the net contribution portion for your RRSP (up to the pre-tax amount, $15,000 in our example) to maximize the offsetting RRSP deduction for Canadian taxes.

7. The 15% to 30% withholding tax paid to the IRS in #3 above may be claimed as a foreign tax credit (FTC) for Canadian tax purposes in the same year. You will need additional income in Canada and have a high enough tax rate to offset this amount. **FTCs may require a more detailed explanation from a qualified accountant.**

For this rollover to qualify, the CRA has stated to us that the full amount must be taken as a lump sum, (not yearly amounts for example) and that full amount is included in the taxpayer’s income. The IRA also must have been funded by the taxpayer, and this is important because it generally excludes Inherited or Beneficiary IRAs from eligibility. SEP-IRAs and Simple-IRAs are also excluded at the time of this writing.

The 401k must also be a transferrable plan with a lump sum transfer in recognition of pension or superannuation tenure and employment services

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rendered while a non-resident of Canada. There are different rules for individuals living in Canada and working in the US or in the case of temporary employees working in the US for less than 5 years.

The withholding tax paid to the IRS that is claimed as a foreign tax credit in Canada requires the advice of a qualified cross-border tax accountant.

Generally, the withholding taxes paid in the US can be used to reduce the Canadian federal tax liability on foreign income earned (Canadian earnings) although not necessarily on a one-to-one basis. If you don't have any US earned income, you may not be able to claim the FTCs. Also note, FTCs may not offset Provincial taxes.

Bear in mind that you haven't really paid tax to Canada yet on the IRA withdrawal, only to the IRS. Therefore, you need to have enough Canadian income tax owing from certain sources in order to utilize the FTCs. Canada views the IRA withdrawal as a transfer while the US may view it as an early lump sum withdrawal and may apply a 20% withholding tax (instead of 15% or 30%). Again, it's important to ask your plan provider which tax rate they would apply and to argue for the 15%.

Furthermore, you should also discuss the transfer with your accountant as well as the Canada Revenue Agency to understand your personal tax liability and any benefits that may be affected once withdrawals begin.

A distinction also applies if the IRA account has been subject to proceeds from a Roth conversion Such conversions could potentially complicate the account and this technique would become muddied because Canada does not recognize Roth plans in the same context as "foreign retirement arrangements." Furthermore, TFSAs and Roth IRAs are separate categories with another set of rules and guidelines for anyone wishing to move across jurisdictions.

RRSP has a future tax liability – you'll pay taxes on RRSP/RRIF withdrawals

A primary drawback to this option is that, after navigating the tax complexities to try to recover taxes paid after making the IRA withdrawal and conversion to the RRSP, you will need to pay taxes again when making withdrawals from your RRSP or RRIF in retirement and could eventually pay taxes twice on the same assets. However, the investments in the RRSP will at least grow tax-deferred, just like they would have within the IRA or 401k.

Can you transfer from RRSP/LIRA to IRA?

Thus far we have only explored the mechanics of a person moving from the US to Canada but what solutions exist for a person moving from Canada to the US? Unfortunately, Canadian registered plans (RRSPs or LIRAs, etc.) cannot be transferred to an IRA. Please also be aware that the place and timing of these transactions should be aligned with pre- and post-move planning that captures the realities of residency and ceasing of non-residency. Many aspects of the information contained herein can also be applicable to retirement arrangements from other countries like the United Kingdom.

Does a 401k to RRSP rollover make sense from an investment perspective?

It's easy to get caught up with taxes and forget that wisely investing can provide a greater long-term impact on your wealth. From an investment perspective, it's not necessary to convert an IRA to an RRSP because you achieve tax-deferred

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growth in both vehicles and will pay tax on withdrawals in either case.

Some advantages to having USD

It's worth considering that most investment options are priced in $USD. Whether you want to buy (for example) shares of Visa, Amazon, Disney, Johnson & Johnson, Unilever, or another multinational blue-chip, the majority of these are priced in USD, and won't cost any less whether you buy them in your RRSP or IRA. Transferring your IRA to an RRSP and converting to $CAD, only to buy $USD assets again could needlessly incur FX conversion fees. In addition, buying only Canadian investments could lead to underperformance, considering Canada only makes up about 3% to 4% of the global investable market.

Keeping an IRA in USD currency also provides somewhat of a hedge against market volatility as the USD historically has tended to outperform other currencies ($CAD included) during recessions or times of extreme market volatility. For example, the 2008 Great Recession was primarily a US-led crisis, but the CAD fell from roughly $1.10 to about $0.78 due to investors seeking the safety of US Treasury Bonds.

One drawback might be the potential currency risk from owning a USD portfolio while needing Canadian dollars for cash flow needs. If the CAD were to appreciate, your buying power would diminish. However, this risk can typically be addressed with smart investment planning.

You won't achieve more buying power with a cheaper currency!

We often hear the refrain "*I'll get 30% more if I convert to CAD from USD.*" ***This is incorrect***. You'll have a greater quantity of CAD than USD but no more (or less) buying power within the stock market.

For example, if you wish to purchase 10 shares of XYZ stock on the NYSE, and they cost $10 each, you'll need $100 USD to make that purchase. If you are using CAD to make the purchase, you'll need $100 USD worth of CAD to make that purchase. If the CAD is trading at $0.80 USD/CAD, then you'll need $125 CAD to buy those shares. Your purchasing power is not enhanced by the foreign exchange, even though you have a higher quantity of CAD.

What if you are a US or dual Citizen?

The rollover to an RRSP won't be advantageous as you would still be filing a US return every year and would not qualify for the reduced withholding tax based on the US-Canada tax treaty, and other tax limitations may apply. Normal US withdrawal rules would apply. Generally speaking, there is little practical difference between the RRSP or IRA for withdrawals, but there could be a disadvantage from an investment perspective as described above.

Crossborder Accounting and Legal Resources

If you need a referral to a qualified independent cross-border tax-practitioner, we would be happy to provide you with suitable options. To avoid conflicts of interest, Pacifica Partners does not perform tax returns and is not an accounting firm.

For further information, please feel free to contact the author ***Naveen Gopal*** *at* *naveen@pacificapartners.com* *or at* ***1-877-576-8908***.

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