



Wealth
Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Taxation of a tax-free savings account (TFSA) for U.S. persons

Understanding the U.S. tax implications

A TFSA is a flexible savings vehicle where investment income earned (and growth) in the account is tax-free for Canadian tax purposes. However, U.S. persons who hold a TFSA may be subject to additional tax and filing requirements. Therefore, it's important that you obtain advice from a qualified tax advisor before you open a TFSA. 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 has a TFSA.

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 does not 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 and estate planning benefits of a TFSA. If you would like further information on the TFSA, 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). A TFSA 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 invest in a TFSA. In particular, you'll want to consider the after-tax return of investing in this account, taking into consideration the U.S. tax implications and any additional compliance cost you may incur as a result of investing in a TFSA.

Contributions to a TFSA

A TFSA is not a tax-free account from a U.S. tax perspective and may be classified as a foreign grantor trust to a U.S. person who makes contributions to the plan.

Unfortunately, the Treaty does not provide any relief for a TFSA held by a U.S. person. You will generally be subject to U.S. income tax annually on investment income, including realized capital gains, earned in your TFSA. Any income earned in the plan maintains its character for U.S. income tax purposes. If you hold investments that are considered passive foreign investment companies (PFICs), such as Canadian mutual funds and exchange traded funds (ETFs), you may also 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.

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Since Canadian tax rates are generally higher, if you have paid Canadian taxes on other investment income in the current or prior years, you may have accumulated unused foreign tax credits under the U.S. tax rules. You may be able to use these foreign tax credits to reduce your U.S. income taxes on income and capital gains earned in your TFSA.

A TFSA classified as a foreign grantor trust may also trigger foreign trust filing requirements. In recent years, the U.S. government has provided some exemptions for certain tax-favored de minimis savings trust, however the relief may not extend to TFSAs. You should speak with your qualified cross-border tax advisor to determine if relief for foreign trust reporting is available for your particular circumstances.

You should consult with your qualified cross-border tax advisor to determine if you should set up and contribute to a TFSA. A careful analysis should be completed to understand the potential U.S. tax liability and any associated fees for additional filing requirements apply.

Withdrawals from your TFSA

Withdrawals from your TFSA can generally be received tax free in the U.S., although additional reporting may be required. However, any income earned and capital gains realized within the TFSA prior to the withdrawal is still fully taxable for U.S. tax purposes.

U.S. transfer tax implications

Gift to your spouse to contribute to their TFSA

In general, you cannot contribute to your spouse's TFSA directly (as only a holder can contribute to their own TFSA). However, if you gift funds to your spouse to enable them to make contributions, you may be exposed to U.S. gift tax if your spouse is not a U.S. citizen and to the extent you exceed the available gift tax annual exclusion for gifts to a non-U.S. citizen spouse.

If your spouse is a U.S. citizen, there is no U.S. gift tax for funds gifted to them that are contributed to a TFSA. Your U.S. citizen spouse will be subject to the U.S. tax and the foreign trust reporting requirements in respect of their TFSA, as discussed earlier in this article.

Taxation of your TFSA at death

If the successor holder or beneficiary of your plan is your U.S. citizen spouse, you will not be subject to U.S. estate tax on the TFSA assets upon your death.

If your beneficiary or successor holder is your non-U.S. citizen spouse, or is someone other than your spouse, you may be subject to U.S. estate tax on the FMV of your TFSA, to the extent any credits or deductions you may be entitled to do not otherwise eliminate or defer your estate tax liability.

U.S. beneficiary or successor holder

A U.S. beneficiary or successor holder of your TFSA is not exposed to U.S. income or U.S. transfer tax during your lifetime.

For U.S. tax purposes, your TFSA may continue to be classified as a foreign grantor trust until your plan is wound up and a U.S. beneficiary would pick up the income and capital gains earned in the TFSA on their annual U.S. tax return, even if it was not paid out.

Where your U.S. citizen spouse is the successor holder of your TFSA, the TFSA continues to be classified as a foreign grantor trust and your U.S. citizen spouse will be subject to U.S. tax and the foreign trust reporting requirements discussed earlier.

If your beneficiary is a U.S. person and they contribute the property received from your TFSA to their own TFSA, the foreign grantor trust rules will apply with respect to property contributed to their own plan.

As for any U.S. citizen, the FMV of the property in their TFSA, or if proceeds are not held in a TFSA – the property held directly by them, will be included in their taxable estate for U.S. estate tax purposes upon their death.

Summary

A TFSA is a flexible tax-sheltered vehicle that may help you with saving as a Canadian resident. However, as a U.S. person living in Canada, the U.S. tax treatment of a TFSA must be considered. If the resulting U.S. taxes and additional compliance costs outweigh the Canadian tax benefits, it may render the plan unsuitable for a U.S. person. If you're a U.S. person living in Canada, speak to a qualified cross-border tax professional for advice before contributing to a TFSA.

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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