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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Moving to Canada with a U.S. Roth IRA

Don't miss the deadline to file an election in Canada

Moving to Canada with a U.S. Roth Individual Retirement Arrangement (Roth IRA) could result in negative tax implications if you don't plan ahead. This article provides general information for Canadian residents about the U.S. and Canadian tax treatment of a Roth IRA and the possible tax relief under the Canada-U.S. Income Tax Convention (Treaty).

Overview and U.S. tax treatment

A Roth IRA is an individual retirement plan established under the U.S. Internal Revenue Code (IRC).

Contributions to a Roth IRA are not tax deductible and limits apply on the amount you can contribute to the plan each year. There is no age limit on when you can open or contribute to the plan, so you can continue contributing well into your retirement.

You can withdraw contributions from your plan at any time without U.S. tax consequences or penalties. If you withdraw the earnings (growth and income earned in the plan), the withdrawal may be tax-free if you make the withdrawal on or after the date you turn age 59½ and you make the withdrawal no earlier than at least five years after the first contribution you made to any Roth IRA plan that you own. If you don't meet these requirements,

a distribution of earnings will be taxable and an additional 10% early withdrawal penalty may also apply. There are circumstances that may allow you to receive tax-free distributions from the plan earlier; a discussion of these circumstances is beyond the scope of this article.

A Roth IRA may exist throughout your lifetime and does not need to be wound up. There is generally no minimum distribution requirement during your lifetime. On death, you may be subject to U.S. estate tax on the value of your Roth IRA.

Overview of Canadian tax treatment

If you become a Canadian resident, the income accrued in your Roth IRA is subject to Canadian tax annually unless you're eligible for relief under the Treaty (discussed later). What is considered income accrued depends on the legal classification of the plan.

The plan could be classified as a custodial account, trust, annuity contract or an endowment contract. In general, where a Roth IRA is classified as a:

- **Custodial account:** the plan is typically treated like a savings or investment account at a financial institution, brokerage firm or mutual fund company. Interest, dividends and other investment income as well as any taxable capital gains and allowable capital losses derived from the securities held in a Roth IRA custodial account must be included in your Canadian income annually.
- **Trust:** the plan will generally not be considered resident in Canada and, therefore, will be a non-resident trust for Canadian tax purposes, and if the trust earns foreign accrual property income (FAPI), this income will be taxable to you personally on your Canadian tax return.
- **Annuity or endowment contract:** the Canadian tax implications depend on the specific terms of the particular Roth IRA annuity or endowment contract.

Given this complexity, you should consult with a qualified tax advisor to determine how your plan is classified and taxed in Canada.

Canadian tax deferral and exemption under the Treaty

Under the Treaty, your Roth IRA will qualify as a pension, provided that:

- You do not make a “Canadian contribution”; and
- You file a one-time irrevocable election under the Treaty.

Where your Roth IRA is considered a pension, the income accrued in the plan is tax-deferred for Canadian tax purposes under the Treaty. In addition, future distributions from a Roth IRA that qualify as a pension are exempt from Canadian tax under the Treaty where the distributions received are tax-exempt for U.S. income tax purposes or if you are not a U.S. citizen or U.S. resident, the distributions would be tax-exempt for U.S. tax purposes, as if had you been a U.S. citizen or U.S. resident.

Canadian contribution

A Canadian contribution is a contribution made while you’re a Canadian resident, excluding any contributions made before 2009. Rollovers from another Roth IRA or a Roth 401(k) arrangement (Roth 401(k) arrangements are discussed later) are also not considered Canadian contributions. However, rollovers or conversions from a traditional IRA, or a qualified retirement plan (such as a traditional 401(k) or profit sharing plan) to a Roth IRA while you’re a Canadian resident are considered Canadian contributions.

Where your Roth IRA is considered a pension, the income accrued in the plan is tax-deferred for Canadian tax purposes under the Treaty. In addition, future distributions from a Roth IRA that qualify as a pension are exempt from Canadian tax under the Treaty where the distributions received are tax-exempt for U.S.

If you make a valid Treaty election and subsequently make a Canadian contribution to your Roth IRA, the income that has accrued in the plan before the first Canadian contribution continues to be eligible for tax deferral in Canada. In addition, the balance in the Roth IRA immediately before the Canadian contribution will continue to be exempt from Canadian tax when it’s distributed to you, provided it’s also exempt from U.S. tax. Income accrued in the plan after the Canadian contribution is made cannot benefit from the Treaty and is subject to Canadian tax annually based on the legal classification of the plan in Canada. There are no mechanisms to reverse or rectify the tax treatment that will apply once a Canadian contribution has been made.

Deadline to file an election under the Treaty

The filing deadline for the election is the filing due date of your personal tax return for the year you became a Canadian resident (generally April 30 of the year following the year you became a Canadian resident). If you miss this filing deadline, you should contact the Competent Authority Services Division of the Canada Revenue Agency (CRA) for information on how to proceed.

The election is made in the form of a letter, as there’s no prescribed form for this election. A separate election must be filed for each Roth IRA plan you own.

Canadian foreign filing requirements

Canadian residents who hold assets outside of Canada may have foreign reporting obligations. Foreign reporting obligations in respect of a Roth IRA are determined based on the legal classification of your plan. If you’ve filed a Treaty election and have not made Canadian contributions, you’re generally exempt from these Canadian foreign reporting obligations. A detailed discussion of the filing requirements that may apply based on the classification of your Roth IRA is beyond the scope of this article.

Should I collapse my Roth IRA or can I transfer it to an RRSP or TFSA?

You may want to consider keeping the Roth IRA intact rather than collapsing it where the annual earnings in the plan

and future distributions are tax-free for both Canadian and U.S. tax purposes. However, if you're not a U.S. citizen or domiciliary, you should consider your U.S. estate tax exposure since the Roth IRA is considered U.S. situs property. If you have significant U.S. estate tax exposure, you may want to consider whether collapsing the plan to reduce or eliminate your exposure makes sense. For more information on U.S. estate tax for Canadians, ask your RBC advisor for an article on this topic.

A Roth IRA cannot be transferred directly to a TFSA or an RRSP. It must first be collapsed. You can contribute the proceeds to your TFSA and RRSP if you have contribution room. Otherwise, you can invest the proceeds in a non-registered account.

There are several things to keep in mind before collapsing your Roth IRA, including:

- You may trigger Canadian and U.S. tax (for Roth IRA plans that qualify, consider waiting until the distributions can be received tax-free for U.S. and Canadian tax purposes instead);
- If you're a U.S. person, a TFSA is not tax-free for U.S. tax purposes, and if the TFSA is considered a foreign trust (non-U.S. trust), you may be subject to U.S. foreign trust filing requirements; and
- You earn TFSA contribution room while you're a Canadian resident. RRSP room is created in the year following the year you've earned income that's taxable in Canada; therefore, if you just moved to Canada, you may not have sufficient contribution room to contribute to your TFSA or RRSP.

If you decide to keep your Roth IRA, you should confirm with your U.S. financial institution whether they can continue to hold your plan now that you no longer live in the U.S. If the U.S. financial institution cannot hold the plan, you will need to locate another U.S. financial institution who can. Otherwise, you may be forced to collapse the plan. You should speak to a qualified cross-border tax advisor for advice on whether you should keep your Roth IRA.

Inherited Roth IRA

It's possible for a Roth IRA inherited by a Canadian resident to qualify as a pension under the Treaty. Where the deceased plan owner was a Canadian resident the plan will qualify, provided the deceased filed the Treaty election and did not make contributions to the plan while they were a Canadian resident. Plans inherited from a non-resident of Canada may also qualify. The Canadian resident beneficiary who inherits a Roth IRA in these instances should file their own Treaty election and must not make a Canadian contribution to the plan.

A Roth IRA cannot be transferred directly to a TFSA or an RRSP. It must first be collapsed. You can contribute the proceeds to your TFSA and RRSP if you have contribution room. Otherwise, you can invest the proceeds in a non-registered account.

For U.S. tax purposes, a beneficiary (other than a spouse) who inherits a Roth IRA may be subject to required minimum distribution rules. Only a beneficiary who's a spouse can opt to treat the Roth IRA as their own plan and would be exempt from these rules.

If the beneficiary is required to receive distributions, they will be tax-free, provided the distributed amounts would have qualified as tax-free distributions to the Roth IRA owner if they were alive to receive them. Otherwise, the required distributions are subject to U.S. tax in the same manner as it would have applied to the Roth IRA owner during their lifetime.

For Canadian tax purposes, where the Roth IRA qualifies as a pension, the required minimum distribution received by a Canadian resident beneficiary that qualify as tax-free distributions for U.S. tax purposes also qualify as tax-free for Canadian tax purposes. If the plan does not qualify, the beneficiary will be subject to Canadian tax based on the classification of the plan under Canadian tax laws (as mentioned earlier).

Please ask a qualified tax advisor for more information regarding the required minimum distribution rules that may apply to a beneficiary and the U.S. and Canadian tax treatment.

Roth 401(k) and other U.S. retirement arrangements

A 401(k) plan is a type of U.S. company pension plan where an employee can make contributions using pre-tax funds. The employer may also contribute. The IRC allows for a separate Roth 401(k) plan to be created within a 401(k). Employees may opt to designate certain employee contributions made to a 401(k) as Roth contributions. The Roth contributions are made from amounts included in your gross income for U.S. income tax purposes in the year in which the contributions are made. Accordingly, a 401(k) could contain both pre-tax contributions in one account and after-tax Roth contributions in another account. There are other types of U.S. employer-provided pension plans or retirement plans that may have separate Roth plans. Earnings in a Roth 401(k) can grow tax-deferred and may be received free of U.S. tax if certain criteria are met. For

more information about Roth 401(k) plans, please speak to a qualified tax advisor.

For Canadian tax purposes, you do not have to file a Treaty election to qualify for tax-deferred earnings and tax-free distributions for Canadian tax purposes. Since a Roth 401(k) is part of a 401(k) plan, it's the CRA's current view that the Canadian tax treatment of a Roth 401(k) follows the Canadian tax treatment of the underlying 401(k) plan of which it's a part of. Under the Treaty, there's an automatic tax deferral permitted in Canada on the income accrued in a 401(k) and other similar types of U.S. employer-provided pension plans. In addition, when a distribution is received from a 401(k), Roth 401(k) or similar plan, Canadian tax generally will apply only if the distribution is also subject to U.S. tax. In the case of a Roth 401(k), since it's possible for a distribution to be exempt from U.S. tax, the distribution may be exempt from Canadian tax, too.

A Roth 401(k) may qualify as a foreign pension plan for purposes of special provisions contained in the Canadian Income Tax Act, which allows you to deposit funds from collapsing a foreign pension plan to your RRSP/RRIF without requiring you to have or use contribution room. Please ask your RBC advisor for an article on this topic if you'd like more information.

A Roth 401(k) may qualify as a foreign pension plan for purposes of special provisions contained in the Canadian Income Tax Act, which allows you to deposit funds from collapsing a foreign pension plan to your RRSP/RRIF without requiring you to have or use contribution room.

Summary

If you're moving to Canada or have moved to Canada with a Roth IRA, it's important to speak with a qualified tax advisor regarding the plan, as there can be complex Canadian and U.S. tax implications. It's important to understand the tax implications of your specific plan so that you can determine the best course of action going forward.

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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