Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Taxation of Canadian registered retirement savings plan (RRSP) and registered retirement income fund (RRIF) for U.S. persons

Understanding the U.S. tax implications

RRSPs and RRIFs are available to Canadian residents to promote saving for retirement and provide certain tax benefits including a tax deduction and tax-deferred growth. U.S. persons who invest in these plans 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 holds an RRSP/RRIF.

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 (the 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 these registered savings plans. If you would like further information on one or more of these plans, please ask your RBC advisor for separate articles on these topics.

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). Many RRSPs/RRIFs are set up in Canada as trusts and may be treated as foreign trusts 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

The following sections provide an overview of the U.S. tax treatment that applies to a U.S. person who is an annuitant of an RRSP/RRIF based on the U.S. foreign trust rules and the U.S. transfer tax system.

Contributions to your RRSP

In general, RRSP contributions are not tax-deductible in the U.S. like they are in Canada. However, you may not be subject to other adverse tax treatment if you are the annuitant of an RRSP or a RRIF, or if you are designated as a beneficiary or successor annuitant of one of these plans. You should always seek advice based on your particular circumstances from a qualified cross-border tax advisor about whether you should invest in a RRSP/RRIF.

Relief provided by the Treaty

The U.S may classify an RRSP or a RRIF as a foreign grantor trust. Ordinarily, a U.S. person who makes contributions to a foreign grantor trust is subject to U.S. income tax on the income earned in the trust annually and is subject to additional annual filing requirements. The Treaty, however, provides the following relief:

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- An RRSP and a RRIF are treated as pension plans under the Treaty, and as such, you may elect to defer U.S. federal income tax on the income and capital gains earned on property in these plans until there's an actual withdrawal or distribution from these plans. The election to defer is generally automatic and is made by not including the income or capital gains earned in these plans on your U.S. income tax return. You may technically opt not to follow the Treaty and include the income and capital gains earned in the plan annually on your U.S. tax return.
- You are exempt from the additional filing requirements under the U.S. foreign trust rules with respect to an RRSP or a RRIF. This exemption applies regardless of whether you elect to defer the tax on income and capital gains earned in your RRSP or RRIF. However, an RRSP or RRIF may still need to be disclosed annually on foreign bank account reporting (FBAR) and reporting for specified non-U.S. financial assets.
- If you use these plans to invest in a passive foreign investment company (PFIC), which are generally investments classified as non-U.S. investment corporations, such as Canadian mutual funds, you may have relief from potentially punitive U.S. tax and reporting rules (known as 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.
- When you withdraw funds from your RRSP or RRIF, the entire withdrawal is taxable as income in Canada at your marginal tax rate. For U.S. tax purposes, where you have elected under the Treaty to defer U.S. tax until there's a withdrawal, a withdrawal will be considered annuity income and must be allocated between a taxable and non-taxable portion. The non-taxable portion (called the "investment in the contract") is generally calculated in reference to your original contributions. Once the non-taxable portion of the distribution is calculated, the remaining portion would be considered taxable to you. This calculation is highly complex and nuanced and should be discussed with a qualified cross-border tax advisor.

With the Treaty election, both Canadian and U.S. income tax incurs in the same year (i.e. the year when a withdrawal is made). There is generally no double tax

due to the ability to claim a foreign tax credit on your U.S. federal income tax return for the Canadian income taxes you pay on the withdrawal.

While less commonly seen, where you do not elect to defer U.S. taxation of your RRSP or RRIF under the Treaty, you will report the income and capital gains earned in your RRSP or RRIF annually in the same manner as if the plan was a non-registered account. The income earned in the plan maintains its character for U.S. income tax purposes. Such income and capital gain would also become part of your basis ("investment in the contract") in the RRSP or RRIF for future withdrawals.

U.S. state tax

If you're a U.S. person living in Canada, ordinarily you're not subject to U.S. state income tax on your worldwide income. If you have recently moved from the U.S. to Canada, while you will generally cease U.S. state residency for tax purposes, you should note residency for state tax purposes may not be defined in the same manner as residency for U.S. federal income tax purposes. In dealing with a particular state, it is therefore important to review the state residency rules as you may continue to be considered a resident of a state while living in Canada.

Some states, like California, do not recognize the Treaty, and will tax income and capital gains earned in an RRSP or RRIF annually. States may also disallow foreign tax credits for Canadian tax incurred on RRSP or RRIF withdrawals for state tax purposes. Therefore, if you are subject to U.S. state tax, there may be an element of double taxation of the income and capital gains earned in your RRSP or RRIF.

Pension income splitting

In Canada, each person files a separate individual tax return. Under the Canadian tax rules, it may be possible to elect to report up to half of your RRIF withdrawal on your spouse's Canadian tax return. Therefore, from a Canadian tax perspective, it may be beneficial to use pension income splitting when your spouse is in a lower tax bracket than you.

The U.S. gives married couples a choice of filing their income taxes jointly or separately. If you and your spouse file jointly, the use of pension income splitting generally does not pose any tax issues. However, if you file separately in the U.S., there may be a mismatch where the receiving spouse is subject to Canadian tax on the amount transferred while the transferring spouse is subject to U.S. tax on the same income. Since Canadian taxes paid by the receiving spouse may not be claimed by the other spouse as foreign tax credits for U.S. tax purposes, this can result in double taxation.

If a withdrawal from a spousal RRSP is not subject to the Canadian spousal RRSP attribution rules or attribution only applies to a portion of the withdrawal, there may be double taxation.

As such, careful analysis by your cross-border tax advisor is required to determine whether pension income splitting will benefit you.

Contributions to a spousal RRSP

If you, as a U.S. person, make contributions to a spousal RRSP, you are considered to have made a contribution to a foreign grantor trust. As the grantor, you are subject to U.S. income tax on income and capital gains earned on those contributions. However, U.S. tax may generally be deferred due to the Treaty (as discussed earlier).

Withdrawals subject to attribution

When a withdrawal is made by your spouse from their spousal RRSP and is subject to the Canadian spousal RRSP attribution rules, the amount withdrawn will need to be reported on your Canadian tax return. You may also be subject to U.S. income tax on a portion of the withdrawal made by your spouse from the spousal RRSP. As such, you may claim a foreign tax credit for the Canadian tax you incur on the withdrawal to minimize or eliminate double taxation.

Other withdrawals

If a withdrawal from a spousal RRSP is not subject to the Canadian spousal RRSP attribution rules or attribution only applies to a portion of the withdrawal, there may be double taxation. This is because you may be subject to U.S. income tax on a portion of the withdrawal made by your spouse from the spousal RRSP, but your spouse is subject to Canadian income tax on this withdrawal. If you and your spouse file separate U.S. income tax returns or your spouse is not a U.S. person and does not file a U.S. return, you will not be able to claim a foreign tax credit for the taxes incurred by your spouse in Canada on your U.S. tax return. However, if you and your spouse file your income taxes jointly in the U.S., you may be able to claim foreign tax credits for your and your spouse's Canadian tax liability on the withdrawal from the spousal RRSP, which may minimize or eliminate double taxation.

Transfer tax considerations

In general, gratuitous transfers, or gifts, to your U.S. citizen spouse are not subject to gift tax. However, for gifts to your spouse who is not a U.S. citizen, these are subject to an annual gift tax exclusion amount. As a

result, contributions to a spousal RRSP may be subject to U.S. gift tax, if your spouse is not a U.S. citizen and to the extent you have used up your annual exclusion.

Generally, you are not exposed to U.S. estate tax on property in a spousal RRSP on your death. If your spouse is a U.S. citizen, your spouse may have exposure to U.S. estate tax on the FMV of the spousal RRSP or spousal RRIF when they pass away. If your spouse is a non-U.S. citizen, your spouse may have exposure to U.S. estate tax on the property held in the spousal RRSP or spousal RRIF upon their death if the plan holds U.S. situs assets.

Taxation of your RRSP/RRIF at death

In general, when you pass away, your RRSP or RRIF will be wound up, and the FMV of the plan at the date of death will be included in your final Canadian income tax return. There are exceptions to this Canadian tax treatment. For example, if your surviving spouse is named as the successor annuitant of your RRIF, the plan would continue and your spouse becomes the owner of plan. Any tax on the RRIF proceeds that would otherwise result from your death is deferred. If your spouse is named as a beneficiary of your RRSP or RRIF, it may also be possible to defer tax upon death if they transfer the proceeds to their own RRSP or RRIF.

For U.S. estate tax purposes, the property in your plan is generally included in your taxable estate. However, if the beneficiary of your RRSP or RRIF, or successor annuitant in the case of a RRIF, is your U.S citizen spouse, you will not be subject to U.S. estate tax upon your death on the FMV of these plans.

If your U.S. citizen spouse becomes the owner of your RRIF or transfers the proceeds to their own RRSP or RRIF, under the Treaty, U.S. income tax may be deferred until a distribution is made from the RRSP or RRIF. Upon death, as a U.S. citizen, the FMV of the RRSP or RRIF is generally included in the taxable estate of your spouse.

If the beneficiary or successor annuitant is your spouse who is not a U.S. citizen, or is someone other than your spouse, you may be subject to U.S. estate tax to the extent any credits or deductions you may be entitled to claim do not otherwise eliminate or defer your estate tax liability.

In the case of a non-U.S. citizen spouse, this may result in double taxation (i.e. your estate being subject to U.S. estate tax now and your spouse being subject to Canadian income tax on future distributions). You should discuss strategies to minimize or eliminate the possibility of double taxation with a qualified cross-border tax advisor.

If your U.S. citizen spouse becomes the owner of your RRIF or transfers the proceeds to their own RRSP or RRIF, under the Treaty, U.S. income tax may be deferred until a distribution is made from the RRSP or RRIF. Upon death, as a U.S. citizen, the FMV of the RRSP or RRIF is generally included in the taxable estate of your spouse.

If you are subject to Canadian income tax and U.S. estate tax on your RRSP or RRIF, foreign tax credits may be utilized to minimize or eliminate double tax.

U.S. citizen beneficiary or successor annuitant

During your lifetime, a U.S. citizen beneficiary of your RRSP or RRIF, or successor annuitant in the case of a RRIF, is not subject to U.S. income or U.S. transfer tax with respect to your plan.

If your designated beneficiary is someone other than your spouse, there may also be U.S. income tax implications to your U.S. beneficiary with respect to income and capital gains earned on your RRSP or RRIF proceeds after your date of death. In addition, property owned by your U.S. beneficiary directly or through a registered plan may be exposed to U.S. estate tax upon their death.

Your U.S. beneficiary should seek advice from a qualified cross-border tax advisor on tax implications when inheriting proceeds from an RRSP or RRIF.

Summary

RRSPs and RRIFs are a tax-sheltered savings vehicle available to promote saving for retirement and provide certain Canadian tax benefits. For U.S. persons who invest in these plans, they will want to keep U.S. tax laws and compliance requirements in consideration. If you're a U.S. person living in Canada, speak to a qualified cross-border tax professional for advice about saving in an RRSP or RRIF.

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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NAV0330 (10/2025)