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Tax Ramifications of Investing in U.S. Registered and Non-registered Accounts

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Although we share a border with our neighbours to the south, our tax systems differ greatly. Canada taxes individuals based on their country of residency, whereas the U. S. taxes their citizens and green card holders on their worldwide income regardless of where they reside. As such, it can prove challenging for American citizens who take up residence in Canada as they must comply with both tax systems while dealing with the differing tax treatments for the same income earned. To illustrate, we will take a look at some of the differences between investing in registered and non-registered plans in the U.S. and explore the differences in their tax treatments for American citizens residing in Canada versus the U.S.

Retirement Plans

As is the case in Canada, retirement plans in the U.S. can fall under a range of classifications. Depending on how the benefits are determined, the retirement plans are either considered a "defined benefit" or a "defined contribution". In the U.S., a defined benefit is also referred to as a pension. This form of retirement plan is calculated by using a fixed formula with payments being made from a trust fund dedicated to this purpose. With defined contribution plans, the payout is reliant upon investment performance and the amount of money contributed.

Defined Contribution Plans

Profit sharing plans, an individual retirement account (IRA) and a 401(k) are all examples of defined contribution plans. These plans place onus on the investors to select which investment types their funds are to be allocated to. Investors who withdraw these funds prior to reaching retirement age may face a penalty for early withdrawal. This penalty is non-refundable and is not eligible to be claimed on a Canadian income tax return.

Individuals with a 401(k) through their American employer may move their money to an IRA; this can usually be dealt with more easily if done prior to moving to Canada. The caution about this process is that funds should be transferred directly from the 401 (k) to the IRA. If funds are first transferred to the investor prior to being placed in an IRA, 15% will be withheld and remitted to the Internal Revenue Service (IRS).

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It may be difficult to find someone in Canada who will deal with American IRAs; likewise, U.S. brokers are often reluctant to deal with non-residents. It may be possible to have a U.S. bank handle the IRA for a non-resident; however, the selection of potential investments may be more conservative, such as Certificates of Deposits.

Canadian residents do not have to report anything to the Canada Revenue Agency (CRA) to defer the tax on the income earned inside their IRAs or 401(k), whereas Canadian residents would need to report similar information on their U.S. tax returns if they hold a Canadian RRSP or Registered Retirement Income Fund (RRIF).

In the U.S., a "Roth IRA" is a type of non-taxed retirement plan. The difference between this and similar tax advantaged retirement plans is such that tax breaks apply when funds are withdrawn from the plan throughout retirement, rather than at the point in time of making the initial contributions.

For Canadian residents, U.S. Roth IRAs are deemed as pensions. As such, the related distributions from a Roth IRA are typically exempt from Canadian income tax in the same way that residents of the U.S. would be exempt from American income tax. Under the Canada – U.S. Tax Treaty, Canadian residents may defer any taxation with respect to income accrued but not dispersed by the Roth IRA. This deferral holds until such time as either a distribution from the IRA is made or if another plan is substituted in its place. Essentially, the Roth IRA is non-taxable in Canada.

According to the Canada – U.S. Tax Treaty, a Roth IRA will lose its "pension" status should a Canadian resident make any contributions to it; the only exception to this rule is if the payment is a rollover contribution from another Roth IRA. If any other contributions are made, the resulting growth from the time of the contributions will be subject to Canadian income tax in the year of accrual. The IRA is then divided into two categories; the original "pension" portion that retains its tax exemption status and the taxable, non-pension portion.

Careful planning needs to be undertaken if one wishes to roll their U.S. retirement plan into a Canadian RRSP account. Generally, if an employer contributed to the plan while the employee was a resident in Canada, the employee would not be allowed to roll the plan into an RRSP account on a tax-free basis. The lump-sum payment of the retirement plan would be included in taxable income for the year; however, it may be possible to shelter part of the transfer if there is available RRSP contribution room. If the employer contributed to a U.S. retirement plan while the employee was a resident of the U.S., a rollover into a Canadian RRSP would be possible without affecting the RRSP contribution room.

Non-Registered Accounts

U.S. Mutual Funds

For Canadians who have invested in U.S.-based mutual funds, all distributions from the mutual funds are treated as foreign dividends. However, in the U.S., earnings distributed to the investor retain their nature. For example, capital gain distributions will receive the preferential capital gains treatment on U.S. tax returns. In Canada, . In Canada, they will be taxed as foreign investment income and the full capital gain will be included in income versus 50% of the capital gain as per the Canadian tax treatment. Similarly, U.S. dividends will be taxed in Canada as foreign investment income and not are permitted to take the dividend tax credit which Canadian dividends generate.

Tax-Exempt Interest

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U.S. Partnerships

A fairly common investment structure in the U.S. is a partnership which may hold real estate, for example. The partnership itself is not subject to income tax; however, each partner is subject to income tax on their share of the partnership's income, gains, losses and expenses.

For a Canadian investor, the income of the partnership must be translated into Canadian dollars and must adhere to Canadian accounting rules. For example, if the partnership held depreciating real estate in the U.S., the depreciation is not deductible in Canada and the Canadian capital cost allowance must be calculated based on the historical cost of the asset as measured in Canadian dollars.

Limited Liability Corporations

The use of limited liability corporations (LLCs) are a popular investment tool in the U.S. In this type of entity, the income earned is not taxed at the corporation level, but rather the members are taxed personally, as is the same with partnerships.

In Canada, the Canada Revenue Agency (CRA) does not treat LLCs in the same manner as the U.S. For Canadian tax purposes, LLCs are considered to be a corporation. As such, the individual member will be taxed on the distribution received from the LLC as opposed to their share of the income earned. Unfortunately, this can cause a mismatching of income between U.S. and Canadian taxes. For example, there could be earnings from the LLC in 2011 that will be taxed on an investor's U.S. income tax return even though there may not necessarily have been any distributions made to the investor until the following year. There will be income to report and tax to pay in the U.S. for the 2011 taxation year, but no income nor tax to pay in Canada. Conversely, the investor would receive distributions in 2012, but also have losses allocated to them for tax purposes in the U.S. Under this scenario, there will be income to report on the 2012 Canadian tax return but no U.S. taxes to be claimed against the Canadian income tax. The effect would then be double taxation.

Foreign Income Verification Statement

Canadian residents holding foreign property costing more than C$100,000 must file a T1135 Foreign Income Verification Statement. The T1135 must be filed with the Canadian personal income tax return and discloses what type of foreign property is held (i.e., funds held outside Canada, shares of non-resident corporations, real property outside Canada), what range the cost of the foreign property falls into, where the investments are located and the associated foreign income that is reported on the foreign assets.

Financial planning and tax compliance can be very complex for U.S. citizens and green card holders residing in Canada. To help ensure the completeness and accuracy of tax returns, it is always best to consult a tax professional.

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