Manulife Investments

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Cross-border investment planning

TAX MANAGED STRATEGY 7

There are significant differences in the taxation of investments for Canadians who take up residence in the United States. In order to manage these differences, it's important for individuals to properly structure their investment portfolios before they leave.

When an individual is leaving Canada, questions often arise about whether their investments can continue "as is", and what the tax implications are for their portfolio. This article offers some investment strategies for individuals planning to reside in the United States*.

REGISTERED RETIREMENT SAVINGS PLAN (RRSP)

For U.S. tax purposes, only the income portion of withdrawals from an RRSP is taxable — the capital portion is tax exempt. The capital portion is deemed to be the "original contributions" to the plan and by increasing this amount an individual can reduce the taxable portion of their withdrawals and enjoy significant tax savings.

Individuals should transfer their RRSPs to a new plan before leaving Canada, as the capital portion will now equal the amount transferred into the new plan. A fund switch will not accomplish the "bump up" as it would not change the amount contributed to the plan — it would only increase the adjusted cost base (ACB). The Internal Revenue Service is only concerned with the amount contributed to a plan and not the ACB.

*The U.S. tax rules discussed apply to a "U.S. person" which includes U.S. residents, but also includes U.S. citizens (even those residing in Canada who are Canadian residents for Canadian tax purposes), and U.S. green card holders. Individuals who have to file a U.S. tax return should speak to a cross-border tax specialist about their specific situation.

The different tax treatment of RRSP withdrawals from within Canada and the U.S. provides an opportunity to reduce taxes with proper planning.

TAX FREE SAVINGS ACCOUNT (TFSA)

A non-resident can continue to hold a Canadian TFSA that will be exempt from Canadian tax on its investment income and withdrawals. However, for U.S. tax purposes, the income earned in the TFSA will be taxed each year as there is no treaty relief.

When leaving Canada, individuals should consider liquidating their TFSA investments and withdrawing the proceeds. Remember, the withdrawal will be added back to their unused TFSA contribution room in the following year and may be utilized in the future if they become a Canadian resident again.

REGISTERED EDUCATION SAVINGS PLAN (RESP)

A non-resident can continue to be a subscriber of a Canadian RESP and the funds will be exempt from Canadian tax while in the plan. However, under U.S. tax rules, the RESP is considered a foreign trust with the result that the annual income earned as well as any grant and bond money received in the year is considered taxable income to the subscriber. Because there is no Canadian tax payable on the RESP, there is no offsetting foreign tax credit.

When the beneficiary draws on the RESP for post-secondary education, the accumulated income, grants and bonds are taxed to the student resulting in double taxation. This can be avoided by having a Canadian who is not required to file a U.S. tax return as the RESP subscriber.

TRUST INCOME AND CAPITAL GAINS

Taxable trust income (interest, dividends and foreign income) from mutual funds and segregated fund contracts is reported to non-residents each year as it occurs. Tax withholding on this income in the amount of 15 per cent is generally paid by surrendering units from the funds. Taxes are not withheld on capital gains. However, there is a deemed disposition on these types of investments upon leaving Canada, making any gains or losses subject to Canadian tax laws. Because of this, the decision to hold or sell before leaving Canada is not usually based on Canadian tax considerations.

However, U.S. residents and citizens need to consider U.S. tax rules as well as any additional reporting requirements to U.S. authorities that may apply to holdings in Canadian trusts and corporations.

MAKING IT WORK FOR AN RRSP

Sandra's RRSP has grown to a market value of $350,000. She transfers to a new RRSP just before leaving Canada to increase the capital portion for U.S. tax purposes to $350,000.

If Sandra cashes in her RRSP immediately after her move, the withdrawal would equal the capital portion and be exempt from U.S. tax.[1] The full value of her RRSP would be subject to a 25 per cent withholding tax in Canada, but these taxes ($87,500) can be used as a foreign tax credit in the U.S. Compare this to cashing in the RRSP before leaving Canada — if Sandra is in a 45 per cent tax bracket, $157,500 of her RRSP is lost to taxes.

[1] An election Form 8891 to defer U.S. tax on the undistributed income of a retirement plan until the funds are actually distributed must be attached to the individual's U.S. tax return annually.

For example, U.S. tax rules deem a non-registered investment in a Canadian mutual fund trust or mutual fund corporation to be an investment in a "passive foreign investment company" (PFIC) resulting in unfavourable U.S. tax consequences. A segregated fund is a variable annuity contract and the IRS has not indicated whether it would be subject to the same PFIC rules but other U.S. filing and reporting requirements may be applicable.

TRANSACTION RESTRICTIONS FROM WITHIN THE U.S.

Due to securities regulations, U.S. residents are generally limited to redemptions and otherwise prohibited from managing their Canadian investments from U.S. soil. Certain states allow brokers or dealers to apply for exemptions on registered accounts but no exemptions exist on non-registered accounts. Therefore, it is important that individuals who are leaving Canada realign their portfolios for the long term unless they plan to return to Canada on a regular basis.

IDEAL CANDIDATE

Individuals planning to take up residence in the U.S., and who hold the following investments:

- RRSPs or locked-in RRSPs
- TFSAs
- RESPs
- Non-registered mutual funds or segregated fund contracts

TAKE ACTION

To maximize the tax-efficiency of their portfolio, investors should:

- Transfer their RRSP assets to a new plan before leaving
- Consider liquidating their TFSA investments and withdrawing the proceeds
- Ensure they are not the subscriber of the RESP
- Ensure their portfolio has been structured for a long-term holding period
- Consider holding their non-registered investment funds with an insurance company in a segregated fund contract which may avoid the PFIC rules

Before proceeding with any of these strategies ensure that you speak to a cross-border tax specialist about your personal situation.

INVESTMENT OPTIONS WITH MANULIFE INVESTMENTS

Manulife and its subsidiaries provide a range of investments and services including:

Manulife Mutual Funds provides "best-in-class" portfolio management expertise for our family of funds. Manulife utilizes experienced fund management firms with proven track records for building wealth while managing volatility in varying market conditions. Our broad selection of mutual fund options provide the ability to build fully diversified portfolios to suit a range of investors' needs.

Manulife Segregated Fund Contracts combine the growth potential offered by a broad range of investment funds, with the unique wealth protection features of an insurance contract. Through Manulife segregated fund contracts, investors can minimize their exposure to risk through income, death and maturity guarantees, potential creditor protection features, and estate planning benefits — all from a single product or insurance contract.

FOR MORE INFORMATION, PLEASE CONTACT YOUR ADVISOR OR VISIT MANULIFE.CA/INVESTMENTS

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