Canada-Us Treaty Election For Non-Resident Alien Beneficiaries Of Canadian Pension Plans

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CANADA-US TREATY ELECTION FOR NON-RESIDENT ALIEN BENEFICIARIES OF CANADIAN PENSION PLANS

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This article analyzes the treatment of US beneficiaries of foreign pension plans, including the impact of Code section 72(w). The article explores the use of the special elections for beneficiaries of Canadian pension plans contained in the Canada-US income tax treaty, and suggests a possible alternative solution for situations in which the election is not available.

KEYWORDS: PENSION PLANS • RRSP • TREATY • US-CANADA • US

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INTRODUCTION
A Canadian individual who emigrates to the United States and is a beneficiary of a Canadian pension plan qualifying for tax-favourable treatment in Canada may find himself or herself subject to some interesting tax rules. While many US and Canadian international tax practitioners are familiar with the deferral election contained in article XVIII(7) of the Canada-US treaty,¹ the treaty election interacts in surprising ways with some lesser known (at least to international tax counsel) provisions of the US Internal Revenue Code² that govern the treatment of US beneficiaries of foreign employee pension plans. Those provisions require practitioners to consider some practical points in advising clients. Further, practitioners must consider the benefits of the article XVIII(7) treaty election and determine whether there are situations in which the election is detrimental or unnecessary.

US TREATMENT OF BENEFICIARIES OF QUALIFIED PENSION PLANS
The tax treatment of US beneficiaries of pension plans depends significantly on whether the plan is a “qualified plan.” A qualified plan is, generally, a plan using a trust that is exempt from US income tax. A trust created or organized in the United States and forming a part of a stock bonus, pension, or profit-sharing plan of an employer is generally exempt from federal income taxation under section 501(a) of the Code provided that the trust is a qualified trust that meets the requirements specified in section 401(a). With respect to beneficiaries, section 402(a) provides that distributions received by an employee from an employer trust that is exempt under section 501(a) are taxable by reference to the Code rules that govern the taxation of payments received by the holder of an annuity.³ Annuity payments are taxable as ordinary income except to the extent that the payments represent a recovery of the beneficiary’s “investment in the contract.”⁴ Accordingly, an employee who receives distributions from a qualified pension plan is taxable except to the extent that the distributions represent a recovery of the employee’s investment in the contract—that is, his or her investment in the plan. The employee’s investment in the contract includes not only the employee’s contributions to the plan but also employer contributions that were previously included in the gross income of the employee.⁵

² Internal Revenue Code of 1986, as amended (herein referred to as “the Code”). Unless otherwise stated, statutory references in this article are to the Code.
³ Section 72.
⁴ Sections 72(d) and (e) provide ordering rules for determining whether a payment is allocable to the beneficiary’s investment in the contract.
⁵ Section 72(f).
employee’s investment in the contract also includes employer contributions that were not includible in the gross income of the employee if the contributions would not have been includible in the employee’s gross income if they had been received by the employee directly.  

US TREATMENT OF BENEFICIARIES OF DISQUALIFIED PLANS

If an employees’ trust is not a qualified trust under section 401(a) (for example, because the plan discriminates in favour of highly compensated employees), then the plan is treated as a trust other than a grantor trust, and income earned by the plan, other than income that is currently distributable, is taxable in the hands of the plan. Even though the trust itself is treated as an ordinary non-grantor trust, distributions to the employee are not taxable under the ordinary non-grantor trust rules of subchapter J of the Code but instead are taxable under section 72. In effect, this results in double taxation of income earned by the trust that is not currently distributed since the income is taxable a second time under section 72 when it is distributed to the employee. Contributions to such a trust are taxable to the employee in the year in which the contributions are made by the employer (or in the year in which the contributions vest). Moreover, if one of the reasons for the plan’s failure to qualify for exemption is that the plan is “top heavy,” then in lieu of the employee being taxable on contributions and distributions, any employee who is a highly compensated employee is currently taxed on the annual increase in the value of his or her vested interest in the plan.

6 In other words, the only employer contributions that do not get counted as investments in the contract are those with respect to which the employee escaped taxation solely by reason of the fact that they were made directly by the employer to the qualified trust. See below, however, for a discussion of the special rules that apply to contributions made while the employee was a non-resident alien.

7 The grantor trust rules do not apply to disqualified employees’ trusts: section 402(b)(3). Where the trust is foreign, however, it is taxable only to the extent that it earns income from US sources or income that is effectively connected to a US trade or business. As a non-grantor trust, the trust is entitled to deduct income that is currently distributed to its beneficiaries.

8 A plan is considered to be “top heavy” if it is so weighted toward highly compensated employees that it fails to meet the minimum participation requirements of section 401(a)(26) or section 410(b).

9 The term “highly compensated employee” means any employee who (1) was a 5 percent owner of the employer at any time during the year or the preceding year, or (2) had compensation from the employer for the preceding year in excess of $80,000 and (if the employer elects the application of the following test) was in the top-paid group of employees in that preceding year.

10 Section 402(b)(4).
TREATMENT OF BENEFICIARIES OF NON-US PENSION PLANS

In order for an employees’ trust to be a qualified trust under section 401(a), the trust must be formed or organized in the United States. However, a foreign trust’s inability to qualify under section 401(a) may not be important with respect to the taxation of the trust. As noted above, a foreign pension trust will not itself be subject to US federal income taxation unless it earns US-source income or income effectively connected to a US trade or business. Moreover, in the case of a Canadian pension trust, the trust may qualify for exemption from US withholding tax under article XXI of the treaty.

The disqualification of a foreign trust matters even less from the employee’s perspective; section 402(d) provides that a stock bonus, pension, or profit-sharing trust that does not qualify under section 401 solely because of its foreign status is treated for the purposes of sections 402(a), (b), and (c) as if it were exempt. Thus, the employee may be able to defer inclusion in his or her income any employer contributions to the trust if the foreign plan otherwise meets all of the requirements of section 401. More significantly (since most foreign plans would not meet all of the requirements of section 401), whether or not the foreign trust meets all other requirements of section 401, section 402(b)(3) will prevent the trust from being treated as a grantor trust. Accordingly, the beneficiary employee will not be subject to current tax on income accrued in the trust under the grantor trust rules. Instead, the beneficiary will subject to tax under the rules of section 72 either upon receipt of distributions from the trust or (where the trust violates the minimum participation requirements and the employee is not highly compensated) upon an increase in his or her accrued vested interest.11

US TREATMENT OF FORMER NON-RESIDENT ALIEN BENEFICIARIES

As noted above, the rules of section 72 treat as non-taxable distributions amounts received by an employee that are attributable to the employee’s investment in the contract (investment in the trust). Ordinarily, employer contributions that would not have been includible in the employee’s gross income even if they were received directly by the employee are credited toward the employee’s investment in the trust. Section 72(w) provides a special rule for determining the investment in the contract in situations where the plan beneficiary was a non-resident alien at some point during the life of the plan prior to the year of the distribution. In such a case, the investment in the contract does not include any contribution that was made with respect to compensation for labour or personal services performed outside the United States

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11 However, double taxation in the United States should not result if the trust is earning non-US-source income or is a Canadian trust that is eligible for relief under article XXI of the treaty.
before the individual became a US resident that was not taxable by any foreign country as a result of the contribution to the plan (that is, the compensation would have been taxable under foreign law if paid directly to the employee). Earnings that accrued in the plan before the individual became a US resident that were not taxed to the employee in the United States or in the foreign country are also excluded from the investment in the contract.

Understanding this provision requires reference to its history. The US model income tax convention\(^{12}\) and most US treaties exclusively allocate the right to tax pension distributions earned by a resident of one country from a pension trust that is resident in the other country to the individual’s country of residence. The 1996 US model treaty included a change that was adopted in some later treaties (but not in the Canada-US treaty) which provided that the state of residence of the individual was not permitted to tax pension distributions that were previously taxed in the other state. The Treasury department’s official explanation of the 1996 US model treaty provided that the United States would treat any amount included in the beneficiary’s investment in the contract under section 72 as having been previously taxed in the other country and such amount would not be taxable in the United States.\(^{13}\) In 2004, it was brought to the attention of Congress that the standard treaty allocation provision (actually even the pre-1996 version) resulted in the double non-taxation of foreign pension plan distributions to former non-resident aliens. The double non-taxation resulted from the fact that the United States would not tax the distributions because it would view the original employer contribution that was made before the employee became a US resident as resulting in an increase in the beneficiary’s investment in the contract, which can be received tax-free. At the same time, the foreign country would not tax the distribution because it had ceded its taxing right to the United States under the treaty.

In response to this gap, Congress enacted section 72(w), which provides that contributions that were not taxable in the country of residence do not increase the beneficiary’s investment in the contract for the purposes of section 72. As noted, section 72(w) also applies to earnings that have accrued in the plan tax-free. The exclusion is necessary because earnings accruing tax-free would otherwise be includible in the employee’s gross income under section 402(b)(4) in the year in which the earnings were earned by the trust if the employee was a highly compensated employee of a top-heavy plan, which also would have resulted in an increase in the employee’s investment in the contract.

\(^{12}\) See United States, Department of the Treasury, United States Model Income Tax Convention of November 15, 2006 and the earlier Model Income Tax Convention of September 20, 1996 (herein referred to as “the US model treaty”).

\(^{13}\) United States, Department of the Treasury, United States Model Income Tax Convention of September 20, 1996: Technical Explanation, at article 18, paragraph 1.
US TAX TREATMENT OF RRSPS

Not all pension trusts are subject to the rules of section 402 described above. By its terms, section 402 applies only to an employees’ trust described in section 401(a). Section 401(a) refers to a trust organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of employees or their beneficiaries. Notwithstanding that a qualifying trust is referred to as an “employees’ trust,” a self-employed individual can set up a section 401(a) qualifying trust. Under section 401(c), a self-employed individual is treated as both an employee and an employer for the purposes of section 401 even though the individual is not technically employed by an employer. However, in order to constitute an employee’s trust for the purposes of section 401(a), a plan established by a self-employed individual has to be established with respect to a specific trade or business of the individual that is regarded as the employer with respect to the plan.

A Canadian registered retirement savings plan (RRSP) can be set up by any individual, whether the individual is an employee or is self-employed. Although the individual is allowed to contribute only up to 20 percent of his or her “earned income” for the year (up to a dollar cap) to the RRSP, the RRSP is not required to be formed with respect to a specific trade or business. RRSPs therefore appear (and have been assumed by the Treasury department and the Internal Revenue Service [IRS]) not to be employee pension plans that are subject to the provisions of sections 401 and 402. Accordingly, an RRSP is treated as an ordinary trust subject to taxation under the rules of subchapter J of the Code. Since the grantor and the beneficiary of the RRSP are the same individual, the RRSP is treated as a grantor trust under section 671, and the beneficiary is treated as the owner of the assets and income of the trust. Income earned in the RRSP is taxable currently to the beneficiary in the United States; and, since the beneficiary is treated as the owner of the RRSP’s assets, distributions made by the RRSP to the individual are disregarded. This arrangement can result in double taxation, since any withholding tax imposed by Canada on the ultimate distributions from the RRSP will not creditable if the beneficiary does not have foreign-source income from other sources in the later year.

TREATY ELECTION FOR RRSP BENEFICIARIES

The first protocol to the Canada-US treaty added a new paragraph 5 to article XXIX. The new paragraph added an election for a beneficiary of a Canadian RRSP that is a US citizen or resident:

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14 Section 402.

15 See, for example, Treas. reg. section 1.401-10(b)(2): “If a self-employed individual is engaged in more than one trade or business, each such trade or business shall be considered a separate employer for purposes of applying the provisions of sections 401 through 404 to such individual.”

16 Distributions received by a US resident from an RRSP or other Canadian pension plan are subject to a maximum 15 percent Canadian withholding tax under article XVIII(2) of the treaty.
5. A beneficiary of a Canadian registered retirement savings plan may elect, under rules established by the competent authority of the United States, to defer United States taxation with respect to any income accrued in the plan but not distributed by the plan, until such time as a distribution is made from such plan, or any plan substituted therefor. The provisions of the preceding sentence shall not apply to income which is reasonably attributable to contributions made to the plan by the beneficiary while he was not a resident of Canada.

The RRSP election, which was subsequently moved to article XVIII(7) of the treaty, overrides the grantor trust rules of subchapter J and permits the beneficiary to avoid current inclusion of income earned in the plan. An individual who makes this election is taxable on future distributions from the RRSP under section 72 to the extent that such distributions exceed the individual’s investment in the contract. In effect, this election puts the individual in a similar position to a beneficiary of a section 402(b) plan. As discussed above, under section 72(w) a beneficiary of a section 402(b) plan is taxable on distributions of amounts contributed to, or accrued by, the plan before the beneficiary became a US resident. Could this ever put the individual in a worse position than he or she would be in absent the deferral election?

The answer appears to be no. Unlike an actual employee pension trust, an RRSP should not be subject to section 72(w) even where the plan was funded and accrued income during a period when the individual was a non-resident alien of the United States. Section 72(w) applies only to “employer” or “employee” contributions (or earnings on such contributions), but there is no employer/employee relationship with respect to an RRSP. The individual’s investment in the contract should therefore include tax-free contributions made while the individual was resident in Canada, permitting the individual to withdraw those amounts free of US tax. Likewise, income earned in the RRSP while the individual was resident in Canada should be treated as part of the individual’s investment in the contract since the amounts were treated as owned by the individual under the grantor trust rules prior to the effective date of the treaty election. This conclusion is confirmed by Rev. proc. 89-45, which held that the investment in the contract includes earnings in the plan (but not unrealized appreciation) before the individual became a US taxpayer. Although Rev. proc. 89-45 has been superseded by Rev. proc. 2002-23, the latter procedure does not explain how the investment in the contract is to be determined and contains no indication that the IRS has changed its view on this point.

17 Rev. proc. 2002-23, 2002-1 CB 744. Canadian withholding tax imposed on the distribution from the RRSP should then be creditable against the US tax imposed on the distribution.

18 While section 72(w) would likely also apply to a section 401(a) plan funded by a self-employed individual with respect to a trade or business, since such an individual is treated as the employer and the employee with respect to the plan, an RRSP is not formed with respect to a specific trade or business. See the discussion of this point above.

19 Rev. proc. 89-45, 1989-2 CB 596.

20 Supra note 17.
TREATY ELECTION FOR EMPLOYEE PENSION PLAN BENEFICIARIES

The third (1995) protocol to the treaty moved the RRSP election to article XVIII(7) and expanded the scope of the election to all pension plans. Thus, the deferral election is now available for a Canadian-resident beneficiary of an ordinary employee pension plan, such as a registered pension plan (RPP), who emigrates to the United States. The considerations applicable to such plans are different from those applicable to RRSPs and warrant some more attention. At first blush, it may not be obvious why a deferral election would be necessary for Canadian employee pension plans, given that section 402(b)(3) prevents such plans from being subject to the grantor trust rules. The answer is that the election is helpful to a highly compensated employee of a top-heavy Canadian plan that fails the minimum participation requirements of either section 401(a)(26) or section 410(b). The treaty deferral election overrides section 402(b)(4), which would otherwise require the beneficiary to include in gross income his or her share of the plan’s accrued income.

On closer examination, the deferral election has an even more important benefit. Where a highly compensated employee of a top-heavy plan was formerly a non-resident alien and subsequently emigrates to the United States, the accrued vested benefit for the individual’s first taxable year of US residence would ordinarily include the entire value of the individual’s interest in the plan, and such value would be immediately taxable in full to the extent that it exceeded the employee’s contributions to the plan. The deferral election permits the employee to instead realize such excess value only as distributions are made to him or her from the plan. Thus, the case for making the election here is even more compelling than in the RRSP situation. On the other hand, where the employee is not highly compensated or the plan is not top heavy, the employee is only required to include in income under section 72 amounts actually distributed from the plan. Accordingly, in such situations there appears to be no benefit from the deferral election.

ALTERNATIVE SOLUTION

As discussed above, where a highly compensated employee of a top-heavy plan was formerly a non-resident alien and later emigrates to the United States, the accrued vested benefit for the individual’s first taxable year of US residence would ordinarily include the entire value of the individual’s interest in the plan, and such value would be immediately taxable in full to the extent that it exceeded the employee’s contributions to the plan. While Canadians who emigrate to the United States can use the treaty election to avoid this disastrous result, no such election is available to a beneficiary of such a plan organized in a foreign country other than Canada. Is there an alternative solution to avoid current inclusion under section 402(b)(4)? One possibility that merits further exploration would be for an individual in this situation to consider rolling over the funds in the foreign top-heavy plan to an individual retirement account (IRA) under section 402(c) before moving to the United States. Once the funds are in an IRA, section 402(b)(4) should no longer apply. As noted above,
section 402(d) treats a foreign pension fund like a US fund for the purposes of section 402(c), so at first blush such a rollover appears to be permissible.

CONCLUSION
While the article XVIII(7) deferral election offers a significant benefit to a beneficiary of an RRSP who becomes a US resident, the benefit of the deferral election is even greater for a highly compensated employee who is a beneficiary of a Canadian employees’ pension trust, such as an RPP, that fails the US minimum participation tests. For other beneficiaries of Canadian employees’ pension trusts, the benefits of the deferral election are unclear, but there does not appear to be any downside to the election.