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ADVOCATING FOR ADMINISTRATIVE GUIDANCE ON THE US TAX TREATMENT OF CANADIAN REGISTERED PLANS (THE CANADIAN TAX-FREE SAVINGS ACCOUNT AND RETIREMENT COMPENSATION ARRANGEMENT) AS FOREIGN TRUSTS SUBJECT TO ANNUAL INFORMATION REPORTING REQUIREMENTS
(Forms 3520, 3520-A), (IRC §§ 6048, 6677)

This paper was written by Marsha-laine Dungog, a member of the California Lawyers Association,[1] Jennifer Silvius, and Jonathan Garbutt. The authors wish to thank Michelle Graham and James Meadow for their helpful comments and insights. [2]

Contact Persons:

Marsha-laine Dungog, JD, LLM (Tax)[3]
Withers Bergman LLP
505 Sansome Street, 2nd Floor
San Francisco, CA 94111
+1 415 872 3206
marsha.dungog@withersworldwide.com

Jennifer S. Silvius, JD, LLM (Tax)[4]
Withers Bergman LLP
505 Sansome Street, 2nd Floor
San Francisco, CA 94111
+1 415 872 3203
jennifer.silvius@withersworldwide.com

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[1] The comments contained in this paper are the individual views of the author(s) who prepared them, and do not represent the position of the California Lawyers Association.

[2] Although the authors of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this project.

[3] Ms. Dungog is a U.S. tax lawyer admitted to practice in California and Michigan.

[4] Ms. Silvius a U.S. tax lawyer admitted to practice in New York and North Carolina. She is an associate in the private client and tax group at Withers Bergman LLP.

Jonathan Garbutt[5]
Withers Bergman LLP
505 Sansome Street, 2nd Floor
San Francisco, CA 94111
+1 415 872 3245
jonathan.garbutt@withersworldwide.com

[5] Mr. Garbutt is a Canadian tax lawyer called to the bar in Canada. He has recently joined Withers after practicing as a sole practitioner for over 10 years.

EXECUTIVE SUMMARY[6]

The U.S. taxation of contributions, accruals and distributions from foreign pensions and retirement plans (collectively, "foreign plans") owned by U.S. persons ("USP") remains a controversial area of U.S. tax law that requires definitive guidance as the number of USP residing outside the United States is large and steadily increasing. Complexity arises in part due to the fact that foreign plans often do not fit squarely with the types of plans available to USPs living in the United States. Until the U.S. tax classification and treatment of such foreign plans is addressed by the U.S. Congress or the Department of Treasury, annual U.S. tax reporting of such foreign pensions remains fraught with proverbial "traps for the unwary." In the absence of conclusive guidance from federal tax authorities, many tax practitioners have defaulted to reporting foreign plans owned by USPs (directly and beneficially) as either Code § 402(b) non-exempt employees' trusts, which are not subject to disclosure on Form 3520 and 3520-A under the Internal Revenue Code of 1986 as amended ("Code") §6048 or as foreign grantor trusts under Code §§671-679. These entities are also subject to reporting on the Report of Foreign Bank and Financial Accounts ("FBAR") as required by the Foreign Account Tax Compliance Act ("FATCA"). This repetitive reporting both increases the administrative burden on USPs living abroad and U.S. taxpayers living in the United States who have a beneficial interest in these accounts. The annual reporting, enforcement and collection of information, taxes and penalties on these accounts places additional strain on IRS resources with no corresponding increase in the revenue generated for review of all the information reporting forms filed.

Current U.S. tax laws do not provide any definitive guidance on the treatment of Canadian Tax-Free Savings Accounts ("TSFAs") and Retirement Compensation Arrangements ("RCAs"). As foreign trusts, TSFAs and RCAs would be subject to annual information reporting under Code § 6048 which are made by filing Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts* and Form 3520-A, *Annual Information Return of Foreign Trust with a U.S. Owner* on an annual basis. However, in practice, there is no consensus among cross-border tax practitioners on whether or not these two plans should be subject to any foreign trust reporting. On one hand, TSFAs are

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functionally much more similar to a Roth IRA which is taxed under Code §408A, than they are to a traditional trust taxed under Subchapter J of the Code. A Roth IRA is not subject to any Canadian taxation as long as no contributions are made to the Roth IRA while the USP is a resident of Canada. On the other hand, the RCA has no direct U.S. equivalent. This type of arrangement is structured to incentivize cross-border athletes and executives to work in Canada by (1) reducing the amount of Canada-source compensation income that would be subject to Canadian ordinary tax rates; and (2) allocating a portion of such individual's Canadian-source earnings to a Canadian trust that generates no taxable income. In the rare case an RCA does generate taxable income, it will be highly taxed in Canada and consequently not subject to U.S. tax after application of foreign tax credits for Canadian taxes paid on such amounts. Similarly, in retirement, the distributions from RCAs will be taxed in Canada at ordinary income rates, which are likely to result in no U.S. tax payable under relief is provided under the United States – Canada Income Tax Convention and Protocols (the "Treaty")[7].

For Canadian tax purposes, the TSFA is a tax-deferred Canadian registered plan initially intended to provide additional retirement savings to individuals in addition to Canadian registered retirement plans. It is primarily a contract between a subscriber and a financial institution that will hold the TSFA on behalf of the Subscriber. Under the agreement, the subscriber contributes after-tax dollars to the TSFA of up to a maximum of CAD $6,000 per year. The subscriber's contribution may earn income inside the plan without any current taxation on such accruals. Canadian income tax is also not triggered when distributions are made by the financial institution to the subscriber. The TSFA is therefore very similar to a US Roth IRA, where the USP takes a qualified distribution.[8] There are some subtle differences (such as the absence of an income threshold as a condition for eligibility to contribute to a TFSA, carry forward of unused contributions to future years and ability to withdraw funds without penalty), however, this could be mitigated by providing an exemption from trust reporting until a distribution is made under the plan.

Canadian RCAs are intended to also provide additional retirement savings for individuals particularly for cross-border athletes and executives. It is a contract between an individual (the "Holder") and a participating financial institution (the "Custodian") under which the Holder or their employer makes contributions to RCA trust. These contributions are deductible from the income of the respective

[7] United States – Canada Income Tax Convention, 1984 and Protocols as amended.
[8] Code § 408A(d).

contributor, but all contributions are subject to a 50 percent refundable tax at the time of contribution. Moreover, any income earned in the RCA is also subject to a percent refundable tax in the year such income is earned in the RCA. No tax is paid by the Holder until benefits are received at retirement, but all such distributions are subject to tax in Canada. The refundable 50 percent tax imposed on contributions and earnings are then refunded to the RCA trust at a rate of CAD$1 for every CAD$2 distributed until the refundable tax has been entirely repaid.

Contributions to an RCA may not exceed what is required to fund the "entitlement" under the "generally accepted guidelines" for pensions, or about 70 percent of pre-retirement income for an employee with 35 years of service for a defined benefit plan. Failure to follow the "generally accepted guidelines" increases the risk that Canada Revenue Agency (“CRA”) could deem the RCA not to be an RCA, but rather a salary deferral arrangement with additional substantial tax and penalties payable.[9] To ensure the RCA continues to qualify under CRA's "generally accepted guidelines", the involvement of a qualified actuary is required from time to time.

There are substantial Canadian tax compliance obligations imposed on RCAs; the Custodian must apply for and obtain both a contribution account number before any contributions are made and a distribution account number before any distributions are made. The distributions are also subject to withholding by the Custodian and subsequent further reporting to the CRA.

Due to the absence of specific administrative guidance on the U.S. tax treatment and reporting of TSFAs and RCAs, such foreign plans have been subject to default and inconsistent tax treatment by tax practitioners and USPs. Many USPs and their tax advisors do not view these plans as subject to disclosure at all, some view them as foreign employees’ trusts under Code §402(b) and exempt from disclosure on the Form 3520 and Form 3520-A while others report them as foreign grantor trusts and file the Forms 3520 and 3520-A each year. Since enforcement against foreign entities can be difficult, U.S. tax laws make the USP accountable for filings and liable for any applicable taxes and/or penalties with respect to such filings or failure to file. However, these penalties apply inconsistently to USPs due to the divergent approaches taken to reporting interests in these plans. The civil penalties imposed on inaccurate and untimely filed foreign trust reporting under Code § 6677 are substantial. Therefore, the USP donor/contributor or USP beneficiary faces a

[9] We note that if this reclassification for CRA purposes were to occur, there would be Canadian income tax consequences, which will have a corresponding effect on the U.S. taxable income reported by the USP taxpayer. However, this will likely be resolved via the application of foreign tax credits as applicable.

very high risk of incurring penalties for failing to correctly report an interest in a TSFA or RCA in any given year. This issue is particularly problematic given the low annual contribution limits on the TSFA but substantial carryforward of unused contributions to future years.

The accurate and timely filing of Forms 3520/3520-A was one of six additional international compliance campaigns rolled out by the Large Business and International Division (LB&I)[10] on May 18, 2018. Although this campaign was retired as of the date of this paper, the impact of the Form 3520/Form 3520-A campaign on USPs abroad and in the United States continues to be perpetuated with a flurry of IRS notices issued to taxpayers assessing Code § 6677 civil penalties for failure to comply with Code § 6048 reporting requirements with respect to foreign trusts. Since the statute of limitations ("SOL") for assessing Code § 6677(a) and (b) penalties ends three years after a complete and accurate Form 3520/3520-A is filed, the SOL may remain open for an indefinite period of time. Foreign retirement, pension and savings accounts held by USP individuals as grantors and beneficiaries such as Canadian TFSAs and RCAs are within the category for foreign trusts that are subject to Form 3520/3520-A filing and therefore, penalties for failure to timely file.

Treasury Regulations promulgated under Code § 6048 require both grantors of foreign trusts and beneficiaries of foreign grantor trusts to file the Form 3520 (in the case of an ordinary transfer to the trust) and a Form 3520-A, (foreign grantors), to report their activities and interest. We would propose that the TFSA be exempted from annual foreign trust reporting under Code § 6048 until withdrawals or distributions are received by a USP, similar to reporting requirements similar to the exemptions previously provided for Canadian registered retirement savings plans ("RRSPs"), registered retirement income funds ("RRIFs")[11], Registered Education Savings Plans ("RESPs") and Registered Disability Savings Plans ("RDSPs")[12].

Exempting TFSAs from annual foreign trust requirements also alleviates administrative burdens and costs in administering the foreign trust reporting program. TSFA usually have small balances, but they are currently subject to substantial civil penalties for inaccurate or untimely filed Forms 3520 and 3250-A, in addition to FBAR disclosure. However, the potential for TFSAs to carry

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[10]https://www.irs.gov/businesses/irs-announces-the-identification-and-selection-of-six-large-business-and-international-compliance-campaigns

[11] *See* I.R.S. Rev. Proc. 89-45, 1989-2 C.B. 596; I.R.S. Rev. Proc. 2002-23, 2002-1 C.B. 744; I.R.S. Rev. Proc. 2014-55 IRB 753 (Oct. 7, 2014) at § 2.01

[12] *See* Rev. Proc. 2020-17.

substantial balances is far from remote because the TFSA regime provides for unused contributions to be carried forward to future years. This fact, combined with the ability of a USP taxpayer to exercise discretion and control over the TFSA investments, as well as withdraw amounts from the TFSA for any reason without penalty, would support continued foreign trust reporting obligations for USP account holders of TFSAs in the year withdrawals or distributions are made from a TFSA.

Although more significant amounts are involved for RCAs, such amounts are subject to a substantial 50 percent tax on contribution and 50 percent tax on earnings in Canada. Moreover, withdrawals and distributions can only be made after the employee reaches retirement, and such amounts would be taxed at ordinary rates. Therefore, it would be unlikely that a USP would avoid payment of U.S. taxes on RCA amounts on distribution. We believe that USP taxpayers' compliance burden and the IRS' administrative burden can be greatly relieved if the foreign trust reporting exemption available for Code §402(b) plans are extended to RCAs. Currently, foreign trusts that constitute Code § 402(b) nonqualified deferred compensation trusts are exempted from this tax filing requirement under Code § 6048(3) (B) (ii). These provisions state that contributions made to a nonqualified foreign trust under a plan that provides for pensions, profit-sharing, stock bonus, sickness, accident, unemployment welfare and similar benefits or combination of such contributions are not required to be reported under Code § 6048. Consequently, a USP beneficiary of a Canadian RCA should have no affirmative obligation to file Form 3520 until withdrawals or distributions are made by the RCA trust to the USP beneficiary.

We would recommend that regulations under Code § 6048 be amended or further administrative guidance be issued to clarify the annual foreign trust reporting requirements for Canadian TFSAs, and RCAs on Form 3520 and Form 3520-A as proposed above.

DISCUSSION

I. FOREIGN TRUST CLASSIFICATION

Generally, U.S. citizens and U.S. lawful permanent residents ("Green Card Holders") are treated as U.S. residents for U.S. tax purposes,[13] regardless of where they live in the world. A U.S. resident is subject to U.S. federal income taxation on income from "whatever source derived" including but not limited to compensation for services, pensions and income from an interest in a trust.[14] This general rule of worldwide taxation potentially applies to all distributions received by a U.S. resident from foreign retirement, pension and similar deferred compensation plan arrangements (collectively, "Foreign Plans") unless there is a specific statutory or treaty provision that exempts such income from U.S. tax. In the absence of definitive guidance on how such foreign plans are taxed for U.S. purposes, tax practitioners have reported them as either foreign grantor trusts or foreign non-exempt employees' trusts under the Code which would confer an annual information reporting obligation for U.S. residents who have beneficial interests in such foreign trusts. These are discussed further below.

A. Foreign Grantor Trusts

As a preliminary matter, trusts are classified for U.S. tax purposes as either foreign or domestic trusts under Code §§ 7701(a)(30)(E) and (31)(B). Under these provisions, a trust is presumed to be a foreign trust unless the following conditions are satisfied: (1) a court or courts within the United States would be able to exercise primary supervision over administration of the trust, and (2) one or more USPs have the authority to control all substantial decisions of the trust. Treasury Regulation § 301.7701-7 provides that a trust would be treated as a U.S. person on any day that the trust meets the "court test"[15] and the "control test." Based on our understanding of Canadian RCAs and TFSAs, these would likely be classified as foreign trusts for U.S. tax purposes because (1) they are Canadian resident trusts that are controlled by Canadian resident custodians and trustees and (2) a U.S. court would not have primary supervision over the administration of these trusts.

As foreign trusts for U.S. tax purposes, all contributions, income and earnings of the trust would potentially be included in the gross income of their USP beneficiaries under Code §§ 671 - 679. This determination is made after considering the applicable U.S. tax laws and regulations below.

1. *Subchapter J Taxation*

Generally, Subchapter J of the Code[16] provides for taxation of trust income to a trust or its beneficiaries. Under Code § 641, a trust's taxable income is taxed to the trust or its

[13] *See* Code § 7701(b)(1)(A).

[14] *See* Code §§ 61(a)(1), (11), (15).

[15] Treasury Regulations § 301.7701-7(c)(3). Safe harbor for the court test is met if the trust instrument does not direct that the trust be administered outside the United States; the trust is in fact administered exclusively in the United States; and the trust is not subject to an automatic migration provision under Treas. Reg. § 301.7701-7(c)(4)(ii).

[16] Subpart J of the Code (Code §§ 641-692) provides for the taxation of trust income.

beneficiaries unless either Code § 651 or § 661 applies because the income is distributed or required to be distributed to the beneficiaries. If either Code § 651 or § 661 applies, the beneficiary is taxed on the qualifying income, and the trust receives a corresponding deduction. However, Code § 643(a) generally provides that the deduction cannot exceed the trust's "Distributable Net Income" ("DNI"), which in general terms, is the taxable income of the trust with certain modifications.[17] If a trust's DNI for a taxable year is not distributed to the beneficiaries,[18] it is considered "Undistributed Net Income" ("UNI") under Code § 665(a). Generally, no adverse consequences result from a trust declining to distribute all its DNI for a taxable year, except that the trust (which becomes subject to the highest marginal federal income tax rate much more quickly than do individual beneficiaries) will be taxed on the UNI, instead of the beneficiaries.

Because a foreign trust is generally not subject to taxation by the United States on its income, if DNI is not distributed to its beneficiaries who are U.S. residents, taxation on this income will be generally deferred. To discourage foreign trusts from deferring distribution of DNI to its U.S. beneficiaries, Code §§ 665 through 668 provide that if a foreign trust makes distributions of UNI (from preceding tax years) to the U.S. beneficiaries each such distribution is classified as an "Accumulation Distribution". The Accumulation Distribution is allocated to preceding years and subject to tax, including an interest charge thereon, intended generally to treat the income as if it had been taxed in the year the income was earned.[19] This interest charge, aka the "Throwback Tax", can result in a significant tax liability for a U.S. resident beneficiary.

Code §§ 671 through 679 (together, the "Grantor Trust Rules") provide an exception to the general taxation regime of subchapter J. Specifically, Code § 671 provides in relevant part that where it is specified in subpart E of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust (hence, such portion is referred to as a "Grantor Trust"), there shall be included in computing the taxable income and credits for the grantor or the other person those items of income, deductions and credits against tax of the trust which are attributable to that portion of the Grantor Trust (to the extent that such items would be taken into account under this chapter in computing the taxable income or credits against the tax of an individual). Any remaining portion of the trust shall be subject to subparts A through D of subchapter J. Hence, the income, deductions and credits of the Grantor Trust are included in the computation of the grantor's taxable income and not in the taxable income computation of a trust or its beneficiaries as would otherwise be required under Code § 641. Consequently, neither the DNI nor UNI is generally taxable to beneficiaries receiving distributions from a Grantor Trust.
Code §§ 671 through 679 potentially apply to an RCA or TFSA when a beneficiary of such trust is or becomes a U.S. resident for U.S. tax purposes ("U.S. Resident Beneficiary"). Code § 679(a) and related provisions provide that a USP who directly or indirectly transfers property to a foreign trust (other than "to certain deferred compensation or charitable trusts") shall be treated as the owner of the portion of such trust attributable to such property if there is a United States beneficiary of the trust for that year."[20] A person treated as "the owner of any portion of a trust" by this subpart

[17] DNI for a U.S. trust is taxable income plus tax exempt income but excluding capital gains and losses. See Code § 643(a) (6).
[18] *See generally*, Code § 662.
[19] *See generally*, Code § 665(b).
[20] Code § 679(a)(1).

of the Code must include income from that portion of the trust's property in his or her personal income.[21]

The Grantor Trust Rules would potentially apply to transfers of property to trusts made by the U.S. resident beneficiary within five years prior to attaining U.S. residency (the "5-year look back period"). Under Code § 679(a), a direct or indirect transfer of property to a foreign trust made by a non-citizen or non-resident of the United States within five years of becoming a U.S. person is treated "as if such individual transferred to "the foreign trust" on the U.S. residency starting date an amount equal to the portion of such trust attributable to the property transferred by such individual to such trust in such transfer."[22] With few exceptions, the gain inherent in transferred assets is fully taxable at ordinary tax rates to a U.S. person who transfers assets to a non-U.S. trust.[23]

If the above Grantor Trust rules apply to the RCA and TFSA, its U.S. resident beneficiary would have U.S. income tax exposure from (1) contributions made to the Trust upon transfer to the trust and (2) accrued income generated by the trust on a current basis. Our position, as discussed below in Section III, is that the Grantor Trust rules do not apply to the RCA because a U.S. resident beneficiary of an RCA cannot access funds contributed to such account by the Canadian employer until retirement similar to a non-exempt employee's trust under Code §402(b). Moreover, amounts in the RCA are already subject to a 50 percent refundable tax in Canada, on contribution and earnings such that the RCA itself is not tax-free. Lastly distributions received by a U.S. resident beneficiary of an RCA would be subject to tax in Canada at ordinary income tax rates and includible in gross income for U.S. tax purposes. On the other hand, a TFSA would be subject to the Grantor Trust rules such that a U.S. resident beneficiary would have current U.S. income tax liability and reporting obligations as further discussed in Section IV.

B. Section 402(b) Non-Exempt Employees Trusts

Generally, Code § 402(a) provides an exemption for amounts received by a beneficiary of an employee's trust[24] that meets the requirements of Code § 401(a) as a "qualified employee's trust" and which is exempt from tax under Code § 501(a) as an "exempt employee's trust". Both the RCA and TFSA would not qualify as an exempt employee's trust because they are foreign trusts rather than domestic trusts as required under Code § 401(a).[25] As a corollary, they will also fail to meet Code § 501(a) requirements for an exempt employee's trust.

Since RCAs and TFSAs are not classified as exempt employee's trusts under Code § 402(a), the taxability of distributions made to a U.S. resident beneficiary would fall under the parameters of Code § 402(b), which applies to non-exempt trusts. Section 402(b) addresses the tax treatment of a beneficiary of a trust that is not exempt under Code § 501(a).[26] Such trusts are

[21] Code § 671.
[22] Code § 679(a)(4)(A).
[23] Code § 684.
[24] We note that the Code does not have a definition of what constitutes an "employee's trust".
[25] Code § 401(a) provisions only apply to "a trust that is created or 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 his employees or their beneficiaries…" Id.
[26] In other words, it governs the taxation of an employee with an interest in a trust associated with a plan that

considered "funded plans" for U.S. tax purposes, because the assets are protected from the claims of creditors of the employer and related entities.[27] Tax practitioners have noted that Code § 402(b) often applies to non-U.S. trust arrangements associated with foreign equity and deferred compensation plans.[28]

Foreign trusts that fall under Code § 402(b) are typically created when an employer enters into a trust arrangement under which the trustee is the legal owner of the trust assets and the employer is the settlor, contributing cash or shares on behalf of an employee. The employee has a beneficial ownership interest in the trust. The right in this interest may be subject to service or performance conditions that must be satisfied in order for the employee's right to be nonforfeitable and in order for the employee to receive a future distribution of trust assets from the trustee. If the amounts contributed are vested[29] upon contribution, then such amounts are treated as taxable compensation income to the employee under Code § 402(b)(1).[30] However, if the benefits vest some time after the contribution is made, then the employee's inclusion into income is equivalent to the fair market value of his interest in the trust as of the vesting date.[31] Eventual distributions from the trust to the employee would be taxable upon receipt under Code § 72 which allows for the amount already taxed at the time of contribution (if applicable) to be taken into account as part of such employee's basis and therefore excluded from additional tax.

Both the RCA and TFSA must run the gauntlet of Code § 402(b) provisions to determine the extent of potential U.S. income tax exposures arising from trust distributions to a U.S. resident beneficiary. Under Code § 402(b)(1), employer contributions to a trust that qualifies as a Code § 402(b) non-exempt funded plan would be currently includible in a U.S. resident beneficiary's gross income as compensation and subject to tax if such amounts are not subject to a substantial risk of forfeiture. As a corollary, eventual distributions to a U.S. resident beneficiary from the trust would be taxable to such beneficiary upon receipt under Code § 402(b)(2), except that amounts already taxed to the beneficiary at the time of contribution would be excluded from the income inclusion amount under Code § 72(w). Moreover, if the U.S. resident beneficiary is a highly compensated employee ("HCE")[32] and the RCA or TFSA fails to meet requirements of a qualified plan for broad coverage[33] and participation of employees,[34] then the U.S. resident

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is not a U.S. tax-qualified plan under Code § 401(a).

[27] *See* Veena K. Murthy, *Selected Cross-Border Equity and Deferred Compensation Issues with Funded Foreign Plans*, Bloomberg BNA Compensation Planning Journal (April 4, 2014). In footnote 3, Murthy commented that such trusts are often referred to as "secular trusts" as opposed to rabbi trusts. The term "rabbi trust" is based on a private letter ruling regarding a rabbi's tax treatment with respect to assets contributed to a trust by his congregation under which payments could occur only when his service ended. The IRS ruled that the amounts were not taxable when placed in the trust because the assets were subject to the claims of creditors of the congregation. See Priv. Ltr. Rul. 8113107, Rev. Proc. 92-64, 1992-2 C.B. 422; Rev. Proc. 92-65, 1992-2 C.B. 428.

[28] *See* Veena K. Murthy, Selected Cross-Border Equity and Deferred Compensation Issues with Funded Foreign Plans, Bloomberg BNA Compensation Planning Journal (April 4, 2014); Cynthia Blum, U.S. Income Taxation of Cross Border Pensions, Florida Tax Review Vol. 3 No. 6 (1997) reprinted in Tax Analysts (Doc. 97-1191) (January 17, 1997).

[29] The term "vested" means that there is no longer a substantial risk of forfeiture as determined under Code Section 83 principles.

[30] *See also*, Blum, at p. 9.

[31] *See* Treas. Reg. Section. 1.402(b)-1(b)(2).

[32] Code § 402(b)(4)(A).

[33] Code § 401(a)(26).

[34] Code § 410(b).

beneficiary must include in gross income the value of the vested accrued benefit on an annual basis under Code § 402(b)(4). The application of each of these provisions under Code § 402(b)(2) and Code § 402(b)(4) are discussed below.

II. REVIEW OF CURRENT IRS GUIDANCE

The United States has not released any definitive guidance on the US tax classification and treatment of Canadian TFSAs or RCAs. However, there have been opportunities over the last decade for the Treasury and the IRS to address the tax classification and treatment of TFSAs when it issued a series of administrative notices clarifying the US tax classification and treatment of RRSPs and other Canadian registered plans such as RRIFs, Registered Education Savings Plans ("RESPs") and Registered Disability Savings Plans ("RDSPs"). Specifically, since the TFSA was introduced by the Canadian government in 2008, the IRS has released two revenue procedures addressing Canadian registered plans, which could have included TFSAs along with the other administrative guidance provided to simply the U.S. tax reporting obligations of USPs, but they did not. These revenue procedures are discussed immediately below.

In Revenue Procedure 2014-55,[35] the IRS provided guidance for applying paragraph 7 of Article XVIII (Pensions and Annuities) of the Convention[36]. It eliminated previously issued information reporting requirements on USP beneficiaries[37] and annuitants[38] of a Canadian retirement plan[39] to report contributions to, distributions from and ownership of Canadian retirement plans under the simplified reporting regime of IRS Notice 2003-75 (obsoleting as a consequence IRS Form 8891, *U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans*)[40] or pursuant to reporting obligations imposed by Code § 6048 (i.e., IRS Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipts of Foreign Gifts*).[41] It did not, however, affect any reporting obligations for IRS Form 8938, *Statement of Specified Foreign Financial Assets*, under Code § 6038D or FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* (the "FBAR"), imposed by 31 USC Section 5314.[42] Most importantly, it made clear that distributions received by any USP beneficiary or annuitant from a Canadian retirement plan must be included in the gross income of the beneficiary or annuitant for US tax purposes (including the portion thereof that constitutes income accrued in

[35] I.R.S. Rev. Proc. 2014-55 at § 4, 2014-44 IRB 753 (Oct. 7, 2014).

[36] See Convention between the United States and Canada with respect to Taxes on Income and Capital, signed on September 26, 1980, as amended by Protocols signed June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (hereinafter, the "Convention').

[37] Pursuant to Section 3 (Scope) of Rev. Proc. 2014-55, the term "beneficiary" means any individual who holds an interest in a Canadian retirement plan or plans and who would be subject to current U.S. income taxation under the domestic law of the United States on undistributed income accrued in such plan or plans.

[38] Pursuant to Section 3 (Scope) of Rev. Proc. 2014-55, the "annuitant" means an individual who is designated pursuant to a Canadian retirement plan as an annuitant and is not also a beneficiary as defined above.

[39] Pursuant to Section 3 (Scope) of Rev. Proc. 2014-55, the term "Canadian retirement plan" means any trust, company, organization, or other arrangement that is within the scope of Article XVIII (7) of the Convention.

[40] *See* Section 5.02 of Rev. Proc. 2014-55, *Information Reporting With Respect to Canadian Retirement Plans.* Form 8891 was made obsolete as of December 31, 2014.

[41] Indeed, it even eliminated reporting obligations of custodians of Canadian retirement plans to file a Form 3520-A. *See* Section 5. 01 of Rev. Proc. 2014-55, *Information Reporting With Respect to Canadian Retirement Plans*. Section 5.01 was made retroactive and effective for taxable years beginning on or after January 1, 2003.

[42] *Id.* at § 5.

the plan and not previously taxed in the United States) under Code § 72.[43]

In Revenue Procedure 2020-17,[44] the IRS further exempted certain USPs from information reporting requirements imposed by Section 6048 on Canadian RESPs and RDSPs,[45] to the extent such plans constituted "Certain Tax-Favored Foreign Retirement Plans" and "Certain Tax-Favored Foreign Non-Retirement Savings Trusts" (collectively, "Applicable Tax-Favored Foreign Trusts"). However, the exemption only applies to USPs who have been previously compliant with respect to their income tax obligations related to such trusts.

In rendering applicable tax-favored foreign trusts exempt from the annual foreign trust reporting requirements, the IRS pointed out that Code § 6048(d)(4), "*authorizes the Secretary to suspend or modify any requirement under Section 6048 if the United States has no significant tax interest in obtaining requirement information*."[46] The IRS stated:

> *The Treasury Department and IRS have determined that, because applicable tax-favored foreign trusts generally are already subject to written restrictions, such as contribution limitations, conditions for withdrawal, and information reporting, which are imposed under the laws of the country in which the trust is established, and because U.S. individuals with an interest in these trusts may be required under (S)ection 6038D to separately report information about their interests in accounts held by, or through these trusts, it would be appropriate to exempt U.S. individuals from the requirement to provide information about these trusts under (S)ection 6048.*[47]

Based on the narrow definition of "Tax-Favored Foreign Non-Retirement Savings Trust" provided in Section 5.04 of Revenue Procedure 2020-17, tax practitioners were not hard-pressed to ascertain that Canadian RESPs and RDSPs would fall within the exemption from Code § 6048 reporting, because these trusts are organized in Canada exclusively for providing income for medical, disability or educational benefits, and that had limited contributions of $10,000 or less annually or $200,000 or less on a lifetime basis,. Moreover, Canadian RESPs and RDSPs were already subject to strict conditions for withdrawal and annual information reporting by the Canadian government to maintain their status for Canadian tax purposes. The administrative burdens posed by such foreign trusts on IRS resources far outweigh the benefits generated from IRS enforcement efforts directed at delinquent foreign trust filings with respect to USP interests in such assets. Indeed, such assets are low-balance depositary accounts that would be an unlikely offshore vehicle for US tax avoidance by US persons resident in Canada.[48] However, TFSAs and RCAs are not low-value accounts as discussed below.

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[43] *See* Section 6 of Rev. Proc. 2014-55, Distributions from Canadian Retirement Plans.

[44] *See* 2020-17 I.R.B.

[45] *See*, Robert E. Ward, JD LLM, "IRS Provides Reporting and Penalty Relief for Canadian RESP and RDSP Arrangements, As Well as Other Foreign Retirement and Non-Retirement Plan Trusts", BNA International Journal (May 8, 2020).

[46] *See* Section 2.01 of Rev. Proc. 2020-17, *Background.*

[47] *See* Section 3 of Rev. Proc. 2020-17, Information Reporting under Section 6048 With Respect to Applicable Tax-Favored Foreign Trusts.

[48] *See*, Marsha Dungog and Cooper Xu, "Special Report: Should Canadian RESPs and RDSPs Be Exempt from Foreign Trust Reporting?", Tax Notes Federal (July 22, 2019).

III. RETIREMENT CONTRIBUTION ARRANGEMENTS (RCA)

Let's face it. When it comes to the Olympic games, ice hockey is by far the most competitive sport between the United States and Canada. The rivalry between the two countries is epic, dating back to the early days of international hockey and up to the most recent 2022 Beijing Olympic Winter games. Indeed, Canada and the US have faced each other in the championship game of almost every Olympics and World Championships since the beginning of time.

Professional hockey players on both sides of the border pursue lucrative but short careers spanning an average of 5.5 years.[49] It is therefore critical that savings accrued during this period be properly invested for maximum growth and minimal taxation.[50] But Canada's tax regime and rate structure makes tax planning a priority for US athletes playing for Canadian hockey teams. An RCA provides a way for a player to shelter income from taxes during their lucrative years playing for the National Hockey League ("NHL") while spreading tax liability over their post-career years when income is lower. The popularity of RCAs among hockey players is reflected by the fact that all Canadian NHL teams currently sponsor an RCA. Absent an RCA in place, a professional athlete who is a US person ("USP Athlete") would not be incentivized to play for a Canadian team based in Canada because their income and earning potential is substantially front-loaded and therefore subject to considerably higher taxes in Canada than the United States. Therefore, it is very likely that US hockey players who are or have played for one of these teams already have an RCA in place.[51]

Unlike other Canadian registered plans, an RCA allows for funding room that is based on the average of the player's best three years of earnings, with no earnings maximum as would be required in other plans.[52] Before the start of each season, the player can elect how much of their salary is allocated for RCA contributions which would be made by their employer. This ability of the player to control the contribution to an RCA is no different from the ability of an employee to designate contributions to a sponsored-plan or Section 401(k) plan. The contributions are made on a payroll basis with the team on each pay period which is contributed to an investment account (the "RCA Trust"). The contribution and net income earned, or gains realized are subject to a 50 percent tax, which is remitted to a non-interest bearing account, held by the CRA, called a "Refundable Tax Account" ("RTA"). These funds are still assets of the RCA Trust, but do not earn any interest. On retirement, as funds are withdrawn from the RCA, the RCA Trust is reimbursed from the RTA, so the two accounts remain balanced.[53] All funds paid to the player

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[49] https://gblinc.ca/planning-for-the-future-the-rca-and-professional-hockey-players-2/

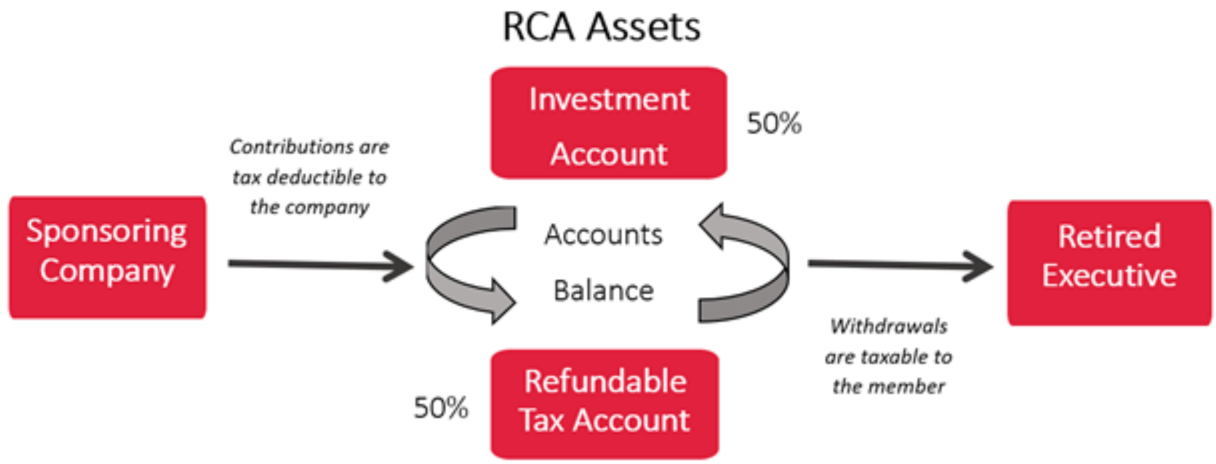
[50] Absent an RCA in place, a professional athlete who is a US person would not be incentivized to play for a Canadian team based in Canada because their income and earning potential is substantially front-loaded and therefore subject to considerably higher taxes in Canada than the United States.

[51] For example, for the 2021-2022 NHL season, 26.6 percent of the active players in the league are American citizens. There are seven (7) Canadian hockey teams, all of which have US citizen players, including star players like Austen Matthews of the Toronto Maple Leafs, Johnny Gaudreau of the Calgary Flames and goalie Connor Hellebuyck of the Winnipeg Jets. Additionally, RCAs are also offered to Major League Baseball ("**MLB**") players, and most of those players are also Americans. For the 2022 season, approximately 65 percent of the players on the Toronto Blue Jays' active roster are US citizens. See https://www.espn.com/mlb/team/roster/_/name/tor/toronto-blue-jays

[52] https://gblinc.ca/planning-for-the-future-the-rca-and-professional-hockey-players-2/

[53] Id.

from the RCA are subject to ordinary income tax rates in the year received.[54]



Above diagram from GBL Insights, Planning for the Future: The RCA and Professional Hockey Players – July 2021, at Planning for the Future: The RCA and Professional Hockey Players - July 2021 - GBL (***www.gblinc.ca***) .

The prevalence of RCAs among cross-border professional athletes, as well as executives and owners of Canadian corporations warrants definitive administrative guidance from the Treasury and IRS on the US tax classification and treatment of these types of compensation arrangements. Failure to do so would perpetuate confusion and delinquency with respect to the US tax classification and treatment of these RCAs as Code §402(b) employee's trusts, which should be exempt from foreign trust reporting by a player who is, or becomes, a USP Athlete.

A. Canadian Tax Classification and Treatment

For Canadian tax purposes, the RCA is a Canadian-resident trust. It is defined under subsection 248(1) of the Income Tax Act of Canada (the "Act") as:

> *a plan or arrangement under which an employer or former employer of a taxpayer, or by a person with whom the employer or former employer does not deal at arm's length, to another person or partnership (in this definition and in Part XI.3 referred to as the "custodian") in connection with benefits that are to be or may be received or enjoyed by any person on, or after or in contemplation of any substantial change in the services rendered by the taxpayer, the retirement of the taxpayer or the loss of an office or employment of the taxpayer…*

The term "RCA" under subsection 248(1) of the Act does not include, among others, a registered retirement plan, a registered pension plan, an employee trust (for life and health), a salary deferral arrangement, a plan or arrangement established for purposes of deferring the salary or wages of a professional athlete for his services with a team that participates in a league having regularly scheduled games.

[54] Id.

The RCA Trust is a non-registered, employer-sponsored and funded plan which is exempt from Canadian taxation under Part I of the Act. However, it is subject to a tax under Part XI.3 which imposes a 50 percent tax on all contributions made and 50 percent tax on any net income earned or gains realized by the Trust. The tax is payable annually, within 90 days after the end of the Trust taxation year and is refundable (aka the "Refundable Tax") to the Trust when retirement benefits are distributed to the player. The Refundable Tax is collected through withholding at source upon contribution to an RCA or distribution to a player pursuant to subsections 153(1) (p-r) of the Act. The Refundable Tax is held in a non-interest-bearing RTA that is repaid to the trust custodian once benefit distributions are paid by the Trust to the player (employee).

B. US Tax Classification and Treatment

1. *Code § 402(b)(2) Application*

Pursuant to Code § 402(b)(1), employer contributions made to a foreign non-exempt trust that constitutes a foreign funded plan would generally be fully includible in the employee's gross income in the year of contribution to the extent such amounts are not subject to a substantial risk of forfeiture. This would generally be the case if the RCA was created for a USP Athlete. If the athlete was not a USP Athlete at the time such amounts were contributed to the RCA Trust, there is no income inclusion with respect to the contributions made by a Canadian employer. Therefore, with respect to the RCA all of the employer contributions made to the RCA Trust for the benefit of the player would be fully includable in the gross income of such player if they were a USP Athlete.

Pursuant to Code § 402(b)(2), distributions received from the RCA Trust would be taxable to the USP Athlete in the year such distributions take place or are made available under Code § 72 subject to certain exclusions as discussed immediately below.

2. *Taxation under Code § 72*

Code § 72(a) provides general rules for income inclusion of any amount received as an annuity. However, when a Code § 402(b) trust is involved, principles under Code § 72 are applied to the distribution amount received by the employee such that only the portion of the distribution that exceeds previously taxed amounts in includible in the distributee's gross income. This applies on a pro-rata basis with respect to each distribution. Code § 72 (b) provides for the exclusion from gross income of that portion of each payment which represents a return of the distributee's investment in the contract.

> Gross income does not include that part of any amount received as an annuity under an annuity, endowment or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date).

As provided above, the portion of the RCA Trust distribution that would be includible in the USP Athlete's gross income (and subject to tax) would specifically exclude amounts which constitute the USP Athlete's investment in the contract. The term "investment in the contract" is defined under Code § 72(c)(1) as:

> *…the investment in the contract as of the annuity starting date (which) is – (A) the aggregate amount of all premiums and other consideration paid for the contract minus (B) aggregate amounts received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.*

To determine which portion of the RCA Trust distributions would be taxable to the USP Athlete as gross income, we would need to determine the portion of the distributions made to the USP Athlete that would, if made, constitute such athlete's investment in the contract and therefore be excludable from his or her gross income.

3. *Exclusion from Gross Income under Code § 72(w)*

Code § 72(w)w) applies to non-exempt foreign trust distributions received by a U.S. resident beneficiary with previously vested contributions in such trust earned entirely while such individual was a non-resident alien performing services outside the United States. Code § 72(w) would exclude from his "investment in the contract" amount that portion of the trust distribution which corresponds to non-taxable contributions ("Non-taxable Contributions") and non-taxable earnings ("Non-taxable Earnings"). In short, such amounts would not be treated as part of his "investment in the contract" that would constitute basis such that it would be generally taxable to the U.S. resident beneficiary. Code § 72(w)(2) defines "non-taxable contributions" and Code § 72(w)(3) defines "non-taxable earnings" as follows:

> ***(2) Applicable nontaxable contributions****…means any employer or employee contributions:*
> A. *Which was made with respect to compensation –*
> *(i) for labor or personal services performed by the employee who, at the time the labor or services were performed, was a nonresident alien for purposes of the laws of the United States in effect at that time, and*
> *(ii) which is treated as sources from without the United States; and*
> B. *Which was not subject to income tax (and would have been subject to income tax if paid as cash compensation when services were rendered) under the laws of the United States or any other foreign country.*
> ***(3) Applicable nontaxable earnings****…. means any earnings:*
> A. *which are paid or accrued with respect to any employer or employee contributions which was made with respect to compensation for labor or personal services performed by the employee,*
> B. *with respect to which the employee was at the time the earnings were paid or accrued a nonresident alien for purposes of the laws of the United States; and*
> C. *which were not subject to income tax under the laws of the United States or any other foreign country.*

Applying the above Code §72(w)(2)(A) to the RCA of a Canadian player before he or she became a USP Athlete (*i.e.*, a U.S. resident for tax purposes) is not an issue. After all, the RCA is an arrangement between the Canadian player and its Canadian employer with respect to services performed in Canada. The primary issue that arises in applying this scenario arises from

Code §§ 72(w)(2)(B) definition of non-taxable contributions and Code. As we previously discussed, 50 percent of the contributions made to an RCA are subject to a Refundable tax amount that is remitted to the CRA. However, such amounts are ultimately refunded back to the custodian of the RCA once distributions from the RCA Trust are made. Therefore, it is unclear whether the Refundable Tax constitutes a foreign income tax for purposes of Code §§ 72(w)(2)(B) and (w)(3)(C) such that contributions and earnings accrued in the RCA Trust would be classified as previously taxed contributions and earnings and constitute part of the USP Athlete's "investment in the contract" not subject to tax upon distribution.[55]

To date, Treasury has yet to promulgate regulations to provide guidance on what would constitute a "foreign income tax" under these provisions. There has, however, been guidance offered under the Treasury Regulations Part III of Subchapter N dealing with foreign tax credits and what would constitute a "creditable income tax" and when such tax is considered to have been paid for purposes of Code § 901. Specifically, Code § 901(b) allows a credit for any foreign "income, war profits, and excess profits taxes." Pursuant to these Treasury Regulations, the predominant character of the foreign tax must be one that is consistent with an income tax in the U.S. sense of the term.[56] This requires that the foreign tax must be "likely to reach net gain in the normal circumstances in which it applies".[57] Although it can be argued that the "Refundable Tax" is not an income tax in the U.S. sense of the term, it is difficult to do so with a high degree of confidence. If we assume, for sake of discussion, that it is an income tax, the next question is whether the contribution and the earnings are "subject to" that tax. To analyze that issue, it is important to understand how the Refundable Tax operates.

Part XI.3 of the Act requires that the employer withhold and remit 50 percent of the contribution to the RCA to the CRA.[58] This creates "refundable tax"[59] The balance of the refundable tax account at the end of the year is compared to the balance at the beginning of the year. If there is an increase, additional refundable tax must be paid in.[60] If, on the other hand, there is a decrease in the balance, then the RCA may receive a refund payment from CRA for the decrease.[61] Income received by the RCA increases the ending balance of refundable tax.[62]The calculation of refundable tax on hand on the end of the year includes a reduction for 50 percent of current distributions.[63] If, for instance, there were no contributions or income during the year and

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[55] We note that a Canadian player who was not a t a U.S. resident (i.e., USP Athlete) at the time contributions and earnings were accruing in the RCA Trust, such amounts would not have been subject to U.S. income tax.

[56] New York State Bar Association, Report No. 1332 Relating to the Definition of a Creditable Tax for Purposes of Sections 901 and 903 (Nov. 24, 2015), p. 6.

[57] Treas. Regs. §1.901-2(a)(3). In Rev. Rul. 67-187, 1967-1 C.B. 185, the Service ruled that the Special Refundable Tax in effect in Canada at the time was not an income tax but, rather, a "compulsory loan" because it was repayable with interest within a specified time. The RCA Refundable Tax may be distinguished from the Special Refundable Tax in that it does not bear interest, an important indicium of a loan, whether compulsory or otherwise, and the timing of the refund of tax can vary according to the pattern of contributions, income and distributions of the particular RCA. Concerning the term "net gain," it does not appear appropriate for either contribution or distributions, which are not "net" of any expenses other than the refundable tax itself.

[58] ITA Regulation 103(7).

[59] ITA 207.5(1) "refundable tax".

[60] ITA 207.7(1).

[61] ITA 207.7(2).

[62] ITA 207.5 "refundable tax".

[63] Id.

the entire RCA balance were distributed, the ending refundable tax balance would go to zero and all refundable tax previously remitted would become refundable. The employer may claim a deduction in the year of the contribution.[64] The employee must include distributions from the RCA in income.[65] When the custodian makes a distribution to the employee, it must withhold income tax at source.[66]

Generally speaking, the phrase "subject to tax" can have the broad meaning of being generally subject to the taxing power or jurisdiction of a tax regime. However, the usage in Code § 72(w)(2) and (3) appears to have a narrower meaning in that this Code section also uses the phrase in saying "would have been subject to income tax if paid as cash compensation." That phrase can be construed to mean, in the reciprocal, that if the employee received a cash payment, it would be taxable. Applying that usage to the RCA, a contribution to the RCA would be "subject to tax" if the RCA were taxed on the receipt of the contribution. Similarly, the income would be "subject to tax," if the RCA were taxed on the receipt of the income. Both the contribution and the income give rise to a payment of refundable tax[67]. However, to the extent that the tax is "refundable", it will be refunded to the RCA Trust one day. Once again, the Treasury Regulations[68] promulgated to address the foreign tax credit regime have contemplated the issue of a tax that is reasonably certain to be refunded and concluded that such a tax is not considered to have been "paid" as stated below:

> *To the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven. It is reasonably certain that an amount will be refunded, credited, rebated, abated, or forgiven if the amount is not greater than a reasonable approximation of final tax liability to the foreign country. (Italics added).*

Based on our understanding of the RCA regime, it would appear "reasonably certain" that the Refundable Tax will be refunded no later than when all the funds of the RCA Trust have been distributed to the employee and the Refundable Tax balance reaches zero. Moreover, the "final tax liability" of the RCA trust would be zero since all Refundable Tax will be refunded to the RCA Trust eventually. It is also clear that the Canadian player who is the employee beneficiary of the RCA Trust will ultimately bear the "final tax liability" because RCA Trust distributions are taxable to the employee and subject to payroll withholding taxes. If such Canadian player migrates to the United States and becomes a USP Athlete, distributions from the RCA would be also subject to Canadian withholding taxes because such amounts would be paid to a non-resident of Canada at the time of distribution. Based on our foregoing review of the RCA regime and manner in which the Refundable Tax is calculated, paid and refunded, we would conclude that RCA contributions earnings accrued in the trust from such contributions are both not "subject to tax" in the sense in which that phrase is used in Code § 72(w)(2) and (3) and,

[64] ITA 20(1)(R). The employer must file T 737-RCA to report the contribution. The RCA also reports the contribution on its T3-RCA. Distributions from the RCA are reported by the custodian on the T4A-RCA.

[65] ITA 56(1)(x)

[66] ITA 153(1)(q).

[67] More precisely, as described in the preceding paragraph, RCA income goes into the overall calculation of the refundable tax balance at year-end, which may or may not require a payment of refundable tax depending on the calculation.

[68] Treas. Regs. §1.901-2(e)(2).

consequently, the RCA contributions are applicable non-taxable contributions and the RCA earnings are applicable non-taxable earnings under Code § 78(w).

We further note that a USP player who migrates to Canada to work for a Canadian employer and establishes an RCA in the course of that employment would not be able to meet the conditions of § 72(w)(2)(B) and (w)(3)(C) to include contributions and earnings in the RCA while he was a resident of Canada in his "investment in the contract". This is because notwithstanding the status of the Refundable Tax as a foreign income tax for U.S. foreign tax credit purposes, such USP Athlete would be subject to US tax on his worldwide income (which would include the contributions and earnings in an RCA established for his benefit by the Canadian employer).

Our review of the legislative history of Code § 72(w) supports our conclusion that both contributions and earnings accrued in the RCA Trust would be subject to U.S. tax upon distribution to the Canadian player if he or she were to become a U.S. resident for tax purposes (i.e., a USP Athlete) or the USP player who migrates to Canada to work for a Canadian employer. The House Conference Report to H.R. 4520 the American Jobs Creation Act of 2004 ("**Conference Report**") [69] which codified Code § 72(w) specifically stated that it was the intent of Congress to remain consistent with U.S. Model treaty provisions which provide for exclusive residence-based taxation of pension distributions to the extent such distributions were not previously included in taxable income in the other country.[70] The codified version of Code § 72(w) would exclude from a taxpayer's basis certain contributions and earnings which were not previously taxed while the taxpayer was a non-resident alien employee. The Conference Report[71] explicitly states:

> *The following example provides how the conference agreement could affect the amount of distribution that may be taxed by the United States pursuant to a tax treaty.*
>
> *Assume the following facts. A, a non-resident alien individual performs services outside the United States, in A's country of residence, Country Z. A's employer makes contributions on behalf of A to a pension plan established in Country Z. For U.S. tax purposes, no portion of the contributions or earnings are included in A's income (and would not be included in income if the amounts were paid as cash compensation when the services were performed) because such amounts related to services performed outside the United States. Later in time, A retires and becomes a permanent resident of the United Sates.*
>
> *Under the conference agreement, the employer contributions to a pension plan would not be taken into account in determining A's basis* ***if A was not subject to income tax on the contributions by the foreign country and the contributions would have been subject to tax by a foreign country if the contributions had been paid to A as cash compensation when the services were performed.*** *Thus,*

[69] *See*, H.R. Rep. No. 108-755, American Jobs Creation Act of 2004 Conference Report to Accompany H.R. 4520 at pp. 790-791 (October 4, 2004).

[70] *Id.* at p. 790.

[71] *Id.* at pp. 790-791.

*in those circumstances, A would be subject to U.S. tax on the distribution of all contribution, as such distributions are made***.** *However, if the contributions would not have been subject to tax in the foreign country if they had been paid to A as cash compensation when the services were performed, under the conference agreement, the contributions would be included in A's basis. Earnings that accrued while A was a non-resident alien would not result in basis if not taxed under U.S. or foreign law. Earnings that accrued while A was a permanent resident of the United States would be subject to present-law rules.*

The conference agreement authorizes the Secretary of the Treasury to issue regulations to carry out the purposes of the conference agreement, including regulations treating contributions as not subject to income tax under the laws of any foreign country under appropriate circumstances. ***For example, Treasury could provide that foreign income tax that was merely nominal would not satisfy the "subject to income tax" requirement****.*

The conference also changes the rules for determining basis in property received in connection for the performance of services in the case of an individual who was a non-resident alien at the time of the services, if the property is treated as income from sources outside the United States. In that case, the individual's basis in the property does not include any amount that was not subject to income tax (and would have been subject to income tax if paid as cash compensation when the services were performed) under the laws of the United States or any foreign country.

(Bold and italic fonts added for emphasis).

Based on the above passage, the concept of foreign income tax under Code § 72(w) would exclude merely nominal tax (for example, a low or zero tax jurisdiction). Assuming the Refundable Tax was an income tax, there is an argument that the RCA Trust was subject to nominal tax, if at all, because the Refundable Tax would be ultimately refunded back to the RCA Trust when it commences trust distributions to the USP Athlete.

The Conference Report also illustrates that the foreign country income tax on contributions and earnings in the foreign trust must have been imposed on the non-resident alien himself and not on the foreign trust entity. Based on our review of the RCA structure, it is clear that the Refundable Tax is imposed on the RCA Trust and not on the USP Athlete as the beneficiary of the RCA Trust. Even if the above passage from the Conference Report were expanded to include a foreign income tax on contributions and earnings paid by the foreign trust (instead of the non-resident individual as illustrated in the Conference Report), in the absence of Treasury Regulations under Code § 72(w) directly addressing this issue, we doubt that the Refundable Tax would constitute an income tax in the U.S. sense for reasons already previously discussed. Indeed, the nature of the Refundable Tax is closer to a deposit[72] than a tax since the 50 percent tax on

[72] We note that the Refundable Tax with respect to the RCA is different from the Special Refundable Tax which the Service had previously determined to be a "compulsory loan" than an income tax in Rev. Rul. 67-187, 1967-1 C.B. 185. In Rev. Rul. 67-187, it held that the Special Refundable Tax in effect in Canada at the time was not an

contributions and accrued earnings are ultimately refunded back to the foreign trust when trust monies are distributed to the employee beneficiary (such that the beneficiary, in fact, receives the gross amount initially contributed by the employer and earnings accrued on such amounts). Further, if the contributions were made directly to the non-resident alien employee as cash compensation (rather than the foreign trust), such amounts would have been immediately subject to Canadian income tax as compensation income.

Applying the above provisions of Code §§ 72(w)(2) and (w)(3) to the RCA Trust, we would conclude that the entire amount of the employer contributions made by a Canadian employer to an RCA Trust account for the benefit of its USP Athlete would constitute Non-taxable Contributions under Code § 72(w)(2). We reach this conclusion because all the employer contributions into the RCA Trust were subject to a 50 percent Refundable Tax pursuant to Part XI.3 of the Act. The application of the Refundable Tax to such contributions would not rise to the level of an income tax in the U.S. sense. As a result, the portion of the RCA trust distributions made to a USP Athlete which constitutes Non-taxable Contributions would be subject to U.S. income tax if he or she were to receive such amounts as a resident of the United States under Code §§ 72(a), (c) and (w).[73]

We would also further conclude that a portion of the RCA Trust distributions which represent earnings accrued in the RCA Trust from formation date to present would also constitute applicable Non-taxable Earnings. Such amounts would be excluded from the USP Athlete's investment in the contract amounts under Code § 72(w)(3).[74] This conclusion is reached because all the accrued earnings in the RCA Trust were subject to the same 50 percent Refundable Tax which we do not believe would constitute an income tax in the U.S. sense. Further, a portion of these earnings would not have been subject to U.S. income tax to the extent the amounts were accruing in a foreign trust while the athlete was a non-resident alien.

In light of the above analysis, distributions from the RCA Trust to a USP Athlete (regardless of whether or not he or she became a U.S. resident after establishment of the RCA or was already a USP player at the time of its creation) would be taxable to the individual as gross income subject to U.S. federal income taxes.[75] We also further note that because the RCA Trust distributions would be computed and paid to the athlete based on the Canadian Dollar, the amount

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income tax but, rather, a "compulsory loan" because it was repayable with interest within a specified time. The RCA Refundable Tax may be distinguished from the Special Refundable Tax in that it does not bear interest, an important indicium of a loan, whether compulsory or otherwise, and the timing of the refund of tax can vary according to the pattern of contributions, income and distributions of the particular RCA.

[73] We note that, if the RCA was not subject to the Refundable Tax, then there would be the possibility that a portion of the Employer contributions to the RCA Trust may constitute Nontaxable Contributions to the extent that the USP Athlete: (1) filed a U.S. Form 1040NR to apportion the Canadian hockey team compensation to "services performed within the United States" in the same year as such contributions, and (2) the USP Athlete took a Treaty based position under Article XV:2 of the Tax Treaty to file such returns as a non-resident alien ("**NRA**").

[74] We note that, if the RCA was not subject to the Refundable Tax, then there would be the possibility that a portion of the Earnings accrued in the RCA Trust may constitute Nontaxable Earnings to the extent that the Canadian Athlete: (1) filed a U.S. Form 1040NR to apportion his Canadian hockey team compensation to "services performed within the United States" in the same year that earnings accrued to the RCA Trust, and (2) such athlete took a Treaty based position under Article XV:2 of the Tax Treaty to file such returns as an NRA.

[75] The distribution amounts subject to tax would be equivalent to the FMV of the RCA at the time of distribution reduced by the amount of employer contributions made.

payable to such athlete as gross income each year will fluctuate in terms of U.S. Dollars which would be his or her functional currency as a U.S. resident. Treasury Regulations § 1.72-2(b)(3) would have to be applied to properly take into account the foreign exchange component that would be includable and excludable from such athlete's gross income. [76]

4. *Code § 402(b)(4) Application*

If a plan has a highly qualified employer or an HCE, then Code § 402(b)(4) imposes additional hurdles to show that it meets the requirements of a qualified plan under Code § 401(a)(26) (broad-based retirement plan) and § 410(b) (minimum employee participation). Otherwise, if the plan does not meet the requirements of Code §§ 401(a)(26) or 410(b), then the HCE is required to include in his gross income his vested accrued benefit (above investment in the contract) in the trust as of the end of each trust year that falls within, or which ends with the employee's tax year. If Code § 402(b)(4) applies to the USP Athlete because the RCA Trust fails Code § 402(b)(4) requirements, then he or she would have to include all earnings accrued in the Trust as part of his or her current gross income subject to U.S. tax regardless of actual distributions. For § 402(b)(4) purposes, an HCE is defined under Code § 414(q),[77] as an individual who was a five percent owner[78] of the employer at any time during the year or preceding year, or for the preceding year had compensation[79] in excess of US $80,000 as adjusted annually under Code § 415(d) (i.e., cost of living adjustments). Employees who are non-resident aliens[80] and receive no earned income[81] that constitutes income attributable to services performed in the United States are not treated as employees for purposes of determining HCE.[82]

If the USP Athlete were a non-resident alien when the RCA Trust was funded for his or her benefit for services performed outside the United States, it would appear that the RCA Trust, as a foreign non-exempt trust that is a funded plan, would have no employee that would qualify as an HCE for purposes of determining if the RCA Trust constitutes a foreign funded qualified plan under Code §§ 401(a)(26) and 410(b) until sometime when the such individual became a U.S. resident.

The subsequent issue that arises is that, even if the USP Athlete became eligible for HCE status, he or she would be no longer an employee of the Canadian employer which established the RCA Trust nor receiving any compensation for services provided within the United States to

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[76] Under Treas. Reg. § 1.72-3(b)(3), a certain fixed dollar amount is considered to be the amount received as an annuity and is excludable from your gross income each year. All amounts in excess of a certain fixed dollar amount are considered to be amounts received not as an annuity and therefore includible in your gross income. The excludable fixed dollar amount is determined by dividing the investment in the contract by the number of periodic payments anticipated using the actuarial tables of Treas. Reg. § 1.72-9.

[77] Code § 402(b)(4)(C).

[78] As defined under Code § 416(i)(1).

[79] Compensation within the meaning of Code § 415(c)(3).

[80] Code § 414(q)(8) referencing Code § 7701(b)(1)(B).

[81] Within the meaning of Code § 911(d)(2) which includes wages, salaries and professional fees generally.

[82] There is no guidance from the applicable sections of the Code Regulations or the IRS that a Canadian Athlete would be classified as an HCE if he or she filed a U.S. Form 1040NR and took a Treaty based position for non-resident status under Article XV:2 of the Tax Treaty for years where such athlete earned Canadian employer compensation for services performed with the United States.

the Canadian employer in excess of US $80,000 (as adjusted for inflation) when he or she became a US tax resident. Therefore, such USP Athlete would be ineligible to claim HCE status for his or her US tax residency year under Code § 414(q). Ultimately, the RCA Trust would not have any HCE individual that would trigger the gauntlet rules of Code § 402(b)(4) because the USP Athlete were not an HCE individual on which Code §§ 401(a)(26) and 401(b) tests can be performed.

5. *Classification as Deferred Compensation under Code § 409A*

While it would appear that only distributions received from the RCA Trust would be taxable to the USP Athlete under Code § 402(b) provisions (see above), there remains the risk that accrued earnings in the Trust that remain undistributed may be taxable to the USP Athlete as current income. This risk arises if the RCA Trust constitutes a nonqualified deferred compensation plan under Code § 409A. This statutory provision[83] provides for certain requirements which if violated would cause such athlete to recognize all earnings accrued in the Trust as currently includible in the athlete's gross income to the extent such amounts are not subject to a substantial risk of forfeiture.[84] Consequently, the USP Athlete's exclusive right to receive the Trust assets as the sole beneficiary of the RCA Trust (which likely constitute compensation income) may constitute deferred compensation which will cause the athlete to recognize such accrued earnings as current gross income subject to tax.

Treasury Regulations promulgated under Code § 409(A) (the "409A Regulations") define a nonqualified deferred compensation plan as including a plan under which an employee obtains a legally binding right to receive property in a future taxable year where such property will be substantially vested (as defined under Treasury Regulation § 1.83-3(b)).[85] There are, however, exemptions to what would be considered deferred compensation under the 409A Regulations. Indeed, there are two exemptions in Treasury Regulations § 1.409A-1(b)(6)(i) which may apply to prevent the inclusion of accrued earnings in the RCA Trust as current gross income for U.S. tax purposes. Treasury Regulation § 1.409A-1(b)(6)(i) states:

> *If a service provider receives property from, or pursuant to, a plan maintained by a service recipient, there is no deferral of compensation merely because the value of the property is not includible in income by reason of the property being substantially nonvested (as defined in Section1.83-3(b)), or is includible in income solely due to a valid election under section 83(b). For purposes of this paragraph (b)(6)(i), a transfer of property includes the transfer of a beneficial interest in a trust or annuity plan, or a transfer to or from a trust or under an annuity plan, to the extent such a transfer is subject to section 83, section 402(b) or section 403(c). In addition, for purposes of this paragraph (b), a right to compensation income that will be required to be included in income under section 402(b)(4)(A) is not a deferral of compensation. (Italics added).*

As explicitly stated in the above Treasury Regulation, a transfer of property to a trust which constitutes a right to compensation income is not considered a deferral of compensation

[83] American Job Creation Act of 2004, Pub. L. No. 108-357, Section 885.
[84] *See* IRS Rev. Ruling 2007-48, 2007-30 IRB 129.
[85] Treasury Regulations § 1.409A-1(b)(6)(ii).

for purposes of Code § 409A if it is already subject to the income inclusion rules of Code § 402(b)(4).[86] The USP Athlete would be unable to claim this exemption because we think that the USP Athlete would not be subject to Code § 402(b)(4).

6. *"Substantially Non-Vested"*

The other exemption to Code § 409A under Treas. Reg. § 1.409A-1(b)(6) ((i) involves the transfer of property (such as a right to compensation) to a foreign trust which is a Code § 402(b) plan. Under the above quoted Treasury Regulation, amounts contributed by a Canadian employer to an RCA Trust with the USP Athlete as sole beneficiary would not be treated as deferred compensation under Code § 409A if such athlete's right to such property is substantially non-vested under Treasury Regulation § 1.83-3(b).

Treasury Regulations § 1.83-3(b) provides that property is substantially non-vested when it is subject to a substantial risk of forfeiture and is non-transferable. Both conditions must be satisfied to establish that the property placed in trust is substantially non-vested. A USP Athlete's beneficial interest in an RCA Trust would not be substantially non-vested because of the following reasons:

First, the assets in the RCA Trust are not subject to a substantial risk of forfeiture. Under Treas. Reg. § 1.83-3(c)(1), property is subject to a substantial risk of forfeiture if the transfer has conditions directly or indirectly on the: (1) future performance (or refraining from performance) of substantial services by any person, or (2) the occurrence of a condition related to the transfer, which, if not satisfied, would result in forfeiture.

In a typical arrangement, the Canadian employer would set aside monies in the RCA Trust for the USP Athlete's benefit upon his or her retirement or in the event of loss of employment. There are no conditions that would divest the USP Athlete of his or her right to receive the property before or upon such athlete's retirement. The only implicit condition to the transfer of such property is the passage of time until the athlete retirement or departure from the Canadian employer, and the mere passage of time does not constitute a "risk of substantial forfeiture."

Second, a USP Athlete's right to receive the RCA Trust assets are not non-transferrable because such rights can be sold, assigned or pledged to another person (except the Canadian employer). Treasury Regulations § 1.83-3(d) provides that "the rights of a person in property are transferable if such a person can transfer any interest to any person other than the transferor of the property, but only if such rights in the property are not subject to a substantial risk of forfeiture." Therefore, property is transferrable if the person receiving the property can sell, assign, or pledge (as collateral for a loan or security or any other purpose) his interest in the property to any person other than the transferor of such property. Based on this definition, a USP Athlete's right to receive the RCA Trust assets is transferable and not non-transferable.

Since a USP Athlete's right to receive the RCA Trust assets is not substantially non-vested under Code § 83 and its regulations, there is a risk that the RCA Trust would constitute

[86] Treasury Regulations § 1.402A-1(b)(6)(i).

deferred compensation for Code § 409A purposes. Consequently, the earnings accruing in the RCA Trust would be currently includible in the USP Athlete's gross income under Code § 409A and subject to U.S. tax. We would, however, take the position that the accrued earnings potentially subject to U.S. tax would cover only earnings accrued in the RCA Trust, starting on the date such USP Athlete first became a U.S. resident under U.S. domestic tax laws.

C. US-CANADA TAX TREATY[87]

1. *Article 18*

Article XVIII (1) of the Tax Treaty generally provides that pensions arising in Canada and paid to a resident of the United States may be taxed in the United States but the amount of any such pension that would be excluded from taxable income in Canada if the recipient were a Canadian resident would be exempt from U.S. taxation.[88] For this purpose, Article XVIII(3)(a) defines "pension" as including "…any payment under a superannuation, pension or other retirement arrangement."[89]

The U.S. Treasury Technical Explanation explains that Article 9 of the 1995 Protocol amended Article XVIII (Pensions and Annuities) of the Tax Treaty. Specifically, the present definition of "pension" under Article XVIII (3) was amended by substituting the phrase "other retirement arrangement" for the phrase "retirement plan". Treasury elaborated that:

> The purpose for the change is to clarify that the definition of "pensions" includes for example, Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds ("RRIFs") in Canada, as well as other amounts paid by other retirement plans or arrangements whether or not they are qualified plans under US domestic law; this would include, for example, plans and arrangements described in section 457 or 414(d) of the Internal Revenue Code.

The U.S. Joint Committee on Taxation ("JCT") further commented:[90]

> (9) The existing treaty has a provision limiting source-country taxation of pensions. Article 9(1) of the proposed protocol makes a slight change in the definition of the term "pensions." The protocol clarifies that the definition of pensions includes, for example, payments from a U.S. individual retirement account (an "IRA"), and provides that the definition of pension includes, for example, payments from a Canadian registered retirement savings plan (a "RRSP") or registered retirement income fund (a "RRIF").

Since the RCA Trust is a retirement arrangement that is not an RRSP, RRIF or a qualified plan under Code § 401(a) or Code §§ 457 or 414(d) of U.S. domestic tax law,[91] the

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[87] *Supra* at 4

[88] *See* Article XVIII (1).

[89] *See* Article XVIII(3)(a).

[90] Joint Committee on Taxation, Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada (JCS-15-95), May 23, 1995.

[91] *See also* U.S. Treasury Technical Explanation to the 2007 Protocol, stating: "In addition, a Canadian

question that arises is whether it would nonetheless constitute "another retirement arrangement" under Article XVIII(3)(a) and therefore, a pension. We do not believe that it would qualify as an "other retirement arrangement" because an RCA is not considered among that class of retirement or other employee benefit arrangements favored under Canadian tax laws. Indeed, the JCT noted as follows:[92]

> In addition, under present law, certain Canadian retirement plans that are qualified plans for Canadian tax purposes do not meet U.S. internal law requirements of qualification. The existing treaty, however, permits a U.S. taxpayer who is a beneficiary of an RRSP to obtain U.S. tax deferral corresponding to the deferral that the RRSP provides under Canadian tax law, to the extent that income is reasonably attributable to contributions made to the plan by the beneficiary while he was a Canadian resident (see Rev. Proc. 89-45, 1989-2 C.B. 872). **The proposed protocol expands the class of retirement or other employee benefit arrangements favored by Canadian law with respect to which the United States will grant corresponding deferral of U.S. tax and provides that Canada will provide reciprocal treatment to a Canadian taxpayer who is a beneficiary under a pension plan or other arrangement that qualifies for deferral of U.S. tax under U.S. law. (Emphasis added).**

The above passage confirms that the term "pension" under Article XVIII(3)(a) was expanded to include other retirement plan or arrangements that received favorable treatment under Canadian law that would not satisfy qualified plan treatment under U.S. laws. An RCA does not arguable receive favorable tax treatment in Canada. Indeed, an RCA is omitted from the class or category of retirement plans that would be afforded "qualifying plan" treatment in Canada for purposes of Article XVIII.[93]

The term "qualifying plan" under Par. 15 of Article XVIII is limited to:

> …a trust, company organization or other arrangement that, (a) is a resident of that State, generally exempt from income taxation in that State and operated primarily to provide pension or retirement benefits; (b) is not an individual arrangement in respect of which the individual's employer has no involvement; and (c) the competent authority of the other Contracting State agrees generally corresponds to a pension or retirement plan established in and recognized for tax purposes in that State. Thus, U.S. individual retirement accounts (IRAs) and Canadian registered retirement plans (RRSPs) are not treated as qualifying retirement plans unless addressed in …. **In addition, a Canadian retirement compensation arrangement (RCA) is not a qualifying retirement plan because it is not considered to be generally exempt from income taxation in Canada. (Emphasis added)**

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retirement compensation arrangement (RCA) is not a qualifying retirement plan because it is not considered to be generally exempt from income taxation in Canada."

[92] Supra at 63

[93] Article XVIII (8) through (14) and (15).

Based on the foregoing authorities, we would conclude that the RCA Trust, which is an RCA under Canadian domestic law, would not qualify as a "pension" under Article XVIII(3)(a) of the Treaty. This conclusion stands even if the Canadian Income Tax Conventions Act ("**ICTCIA**") definition of "pension" under Section 5 includes an RCASpecifically: (1) it is evident from the above commentary by the U.S. Department of Treasury and Joint Committee on Taxation on Article XVIII(1) and (3) that only tax favored Canadian plans would be offered Treaty benefits; and (ii) ICTCIA section 5(a) definition of pension only applies in the absence of a treaty definition for pension; and since, Article XVIII(3) defines pension, application of the ITCIA section 5 would be premature. Therefore, a USP Athlete would not be able to apply the provisions of Article XVIII (1) to exclude from the accrued earnings in, and distributions received from, the RCA Trust from U.S. income taxes.

Articles XVIII (7), (8) (9) and (10) all of which deal with the tax relief accorded to pension plans in Canada or the US for the benefit of citizens and residents of the other state would seem to apply at first glance to an RCA. Specifically, that RCAs may be a trust for U.S. tax purposes, but clearly are "other arrangements" that provide for pension benefits. However, these provisions all require that Canada provide tax relief to such a structure in order for the U.S. to grant similar relief, up to the limits of similar relief provided in the U.S. for similar U.S. pensions. Unfortunately, the RCA receives no tax relief, and indeed is taxed and withheld on to the point where, if credit were granted in the U.S., it would be hard to think of a situation where U.S. federal tax would be payable. It could be argued perhaps that an RCA does provide tax relief in that the income of the arrangement is not taxed in the hands of the beneficiary when earned, but it is taxed heavily in the structure. However, that "relief" is technical rather than effective.

2. *Articles XXII (2): Classification as Income from a Trust*

While the RCA does not technically meet the Treaty definition of pension or "other similar arrangement" under Article XVIII as discussed above, it would alternatively qualify as a Canadian resident trust under Article XXII of the Tax Treaty. Specifically, Article XXII (2) of the Tax Treaty provides:

> (1) Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State, except that if such income arises in the other Contracting State, it may also be taxed in that Other State.
>
> (2) To the extent that income distributed by an estate or trust is subject to the provisions of paragraph (1), then, notwithstanding such provisions, income distributed by an estate or trust which is a resident of a Contracting State to a resident of the Other Contracting State who is a beneficiary of the estate or trust may be taxed in the first-mentioned State and according to the laws of that State, but the tax so charged shall not exceed 15 percent of the gross amount of the income; provided however, that such income shall be exempt from tax in the first-mentioned State to the extent of any amount distributed out of income arising outside that State.

If the RCA Trust distributions were treated as a payment out of a trust rather than a pension, and further, as income from the trust rather than capital,[94] then such amounts would be subject to 15 percent withholding tax as income distributed from a trust which is a resident of Canada to a USP Athlete, (if such athlete were to become a resident of the United States), regardless of periodic or lump-sum payments under Article XXII of the Tax Treaty which addresses "other income"[95]. However, since Canadian domestic tax law does not tax distributions from an RCA (in fact, refundable tax is paid back to the RCA as distributions are made), we do not think Article XXII would apply.

IV. TAX FREE SAVINGS ACCOUNTS (TFSA)

The TSFA has proven to be enormously popular with Canadians. According to the latest statistics, there are 14,691,280 unique TFSA holders with a cumulative fair market value of CAD$298 billion.[96] This means that approximately 39 percent of all Canadian residents have a TFSA.[97] Although it is popularly held that there are over one million Americans living in Canada,[98] according to the US government's Federal Voting Assistance Program, which conducts the Overseas Citizen Population Analysis (OCPA) every two years following the general election, there were more than 660,935 eligible US voters living in Canada.[99] Based on the average percentage of Canadian residents owning TFSAs and the statistical numbers available, *ceteris paribus*, there are perhaps as many as 390,000, but more likely closer to 260,000 U.S. Persons who have TFSAs with a market value of perhaps as much as CAD$7.9 billion but perhaps closer to CAD$5.2 billion (or approximately US$6 billion to US$4 billion depending on the assumptions made and the exchange rate).

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[94] Since the reduced rate of 15 percent applies to "income," and not the distribution of "capital" i.e., the employer contribution. See ITA 212(1)(c) also only applies to "income" of the trust that is income with reference to ITA 104(13).

[95] It has been acknowledged by Canadian practitioners that the inclusion of RCAs as "pension" under the Treaty when there is no definition of "pension" under the Treaty results in anomalous results because only periodic payments an RCA can qualify as a "pension" under Article XVIII (2) while lump-sum payments do not. See David W. Ross, RCAs- Withholding Taxes on Retirement Compensation Arrangements, *Taxation of Executive Compensation and Retirement Journal*, Volume XX No. 4 (2009-01-01) commenting on CRA Technical Interpretation 9503510(E).

[96] See https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/income-statistics-gst-hst-statistics/tax-free-savings-account-statistics/tax-free-savings-account-statistics-2019-tax-year.html (site visited March 24, 2022).

[97]Canada's population for 2019, the same year as the latest TFSA stats is 37.5 million according to Statistics Canada see Statistic's Canada's quarterly population estimator at https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1710000901 (site visited March 24, 2022).

[98] See Wikipedia https://en.wikipedia.org/wiki/Immigration_to_Canada. There is no statistical proof of this one million Americans in Canada, but this number shows up all over the internet as the number of Americans living in Canada. Based on the number of potential registered voters, it actually seems like a low number. For example, children of US Persons born in Canada, do not disclose this status in the ordinary course, and many do not know they are US citizens by birth and therefore US Persons for US tax purposes. The authors routinely have to explain this to clients, even highly sophisticated individuals. If there are half a million known US citizens/voters in Canada according to the US government, we would ball-park the actual number of US citizens in Canada at well above 1 million and perhaps closer to 2 million.

[99] https://dailyhive.com/toronto/toronto-us-expat-population, also see https://www.fvap.gov/info/reports-surveys/overseas-citizen-population-analysis. Effectively there are more potential US voters in Canada than in the US states of Alaska, Vermont, North Dakota South Dakota and Wyoming.

Therefore, addressing the issue of exactly what are TSFAs for US tax purposes and how they ought to be reported by US Persons living in Canada is an issue of some significance. This is particularly the case if the reporting is both redundant, and as we know from personal experience, the advice being given to U.S. Persons in Canada by professional advisors with respect to this structure is highly inconsistent.

A. Legal Background

The tax-free savings account (TFSA), introduced in 2009, was intended by the Canadian government to provide an alternative catchment for savings in addition to registered retirement savings plans (RRSPs). [100] It has been described as "*a flexible, registered, general - purpose savings vehicle that allows Canadians to earn tax-free investment income to more easily meet lifetime savings needs*".[101] While the TFSA was intended to complement RRSPs and increase retirement savings,[102] a recent study has asserted that Canadians appear to have diverted their savings away from RRSPs and into TFSAs since the introduction of the TFSA in 2009.[103]

B. TFSA Structure

Canadian TFSAs are intentionally easy to create. All that is required are two parties, i.e., a Canadian resident, as holder, and an entity, as issuer, to enter a "qualifying arrangement" that is treated as a trust. [104] The issuer must be a federally or provincially licensed trust company, a life insurance company qualified to issue annuities or a bank or credit union that is a member of the Canadian Payments Association.[105] The agreement must be a trust agreement with a trust company or an annuity contract with a life insurance company or a deposit agreement with a financial institution.[106] The agreement must also provide that all contributions must be made to the issuer "*in consideration of, or to be used, invested or otherwise applied for the purpose of making distributions to the holder*"[107]. Moreover, the agreement must require that the issuer will file an election to register the arrangement as a TSFA with the CRA before the end of the taxation year in which the agreement is made.[108]

The terms of the agreement must also state, and the issuer must also always comply with, the following terms[109]:

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[100] Introduced by Canadian legislation as Bill C-50, *The* Budget *Implementation Act, 2008* on June 18, 2008. It came into law effective January 1, 2009.

[101] See*,* Jim Yager on behalf of the American Chamber of Commerce in Canada, Letter to the Hon. Mark Mazur, Asst. Secretary (Tax Policy) Dept. of the Treasury and Hon. Robert Stack, Deputy Asst. Secretary (International Affairs) Dept. of the Treasury dated March 16, 2016, *Proposed Tax Relief for Various United States and Canadian Equivalent Purpose Deferred Tax Savings Plans* in 16 TXC (Issue No. 51, March 16, 2016).

[102] Canada, Department of Finance, 2008 Budget, Budget Plan, February 26, 2008, at 277 (https://budget.gc.ca/2008/pdf/plan-eng.pdf).

[103] Leslie Berger, Jonathan Farrar, and Lu Zhang, "An Empirical Analysis of the Displacement Effect of TFSAs on RRSPs" (2019) 67:2 *Canadian Tax Journal* 309-33. https://taxfind.ca/#/document/2019_ctj_paper_2_309

[104] Paragraph (a) of the definition of "qualifying arrangement in subsection 146.2(1)

[105] Paragraph (b) of the definition of "qualifying arrangement in subsection 146.2(1)

[106] Ibid.

[107] Paragraph (c) of the definition of "qualifying arrangement" in subsection 146.2(1)

[108] Paragraph (d) of the definition of "qualifying arrangement" in subsection 146.2(1)

[109] Paragraph (e) of the definition of "qualifying arrangement" in subsection 146.2(1) and subsection 146.2(2)

1) the TSFA must be maintained for the exclusive benefit of the holder;
2) while the holder is alive, only the holder or the issuer can determine the amount and timing of distributions[110] or the investing of funds;
3) no one other than the holder can make a contribution;[111]
4) distributions will reduce any tax imposed for over-contributions[112], contributions by non-residents[113] or as a result of "improper investments" being held in the TSFA[114];
5) the holder has the right to require the issuer to transfer the assets or the value thereof to another TSFA held by the same holder;
6) if the TSFA is a trust, the trust is prohibited from borrowing money or other property for the purposes of the arrangement; and
7) the arrangements must comply with prescribed conditions, of which there have been no such regulations issued to date.[115]

Although the majority of TSFAs are in fact deposit agreements with financial institutions, the terms of the agreement between the holder and the issuer are more trust-like than an ordinary account with a financial institution. It is limited however, on the kind of investments that can be made (although others consider such limits as providing for already for a "wide range of investment options"[116]). Specifically, TFSAs are limited to certain permitted investments similar to RRSPs such as cash, mutual funds, securities listed on a designated stock exchange, guaranteed investment certificates ("GICs"), bonds and certain shares of small business corporations.[117] Because the holder retains significant control over the TFSA and has sole power to direct payments, the TFSA bears the indicia of a grantor trust for U.S. tax purposes (as discussed below), and not a separate entity from the holders as others have suggested.

A Canadian resident aged 18 and older can contribute up to CAD$5,000 (indexed for inflation) of his or her post-tax monies, to a TFSA each year but cannot exceed CAD$ 70,500 for cumulative total contribution for life. Both annual amount and lifetime maximum amount is adjusted annually for inflation. For 2022, the contribution limit is CAD$6,000, for a cumulative total contribution limit of CAD$81,500. Under current legislation, the TFSA annual contribution, if unused, can be rolled over to the succeeding year but will always be subject to the lifetime

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[110] Please see the definition of "distribution" in subsection 146.2(1).

[111] The CRA has indicated that it will allow spouses to provide gifts to each other to fund TSFAs.

[112] Income Tax Act s. 207.02 sets the tax payable for excess contributions to a TSFA at 1% per month, for any month in which there is an excess amount at any time in the month.

[113] Income Tax Act s. 207.03

[114] Pursuant to sections 207.04 and 207.06 there is a tax on the fair market value of Prohibited or Non-Qualified Investments of 50% of the fair market value of the prohibited or non-qualified investment will be payable by the holder of a TFSA if the TFSA acquires a prohibited or non-qualified investment, or an investment held by the TFSA becomes a prohibited or non-qualified investment. This tax can be recovered if the property is disposed of by the TFSA before the end of the calendar year following the calendar year in which the tax arose, and only if it is not reasonable to consider that the TFSA holder knew, or ought to have known, at the time the property was acquired, that it was, or would become, a prohibited or non-qualified investment.

[115] The Explanatory Notes to subsection 146.2(2) state that no specific conditions were anticipated and to date none have been issued. See Canada, Department of Finance, Tax Provisions from the 2008 Federal Budget contained in Bill C-50 with Explanatory Notes.

[116] See Supra Note 83.

[117] https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/tax-free-savings-account/types-investments.html

contribution limit. There is no personal deduction for contributions made to a TFSA. However, neither income earned within a TFSA nor withdrawals from it affect eligibility for Canadian federal income tested benefits such as Old Age Security, the Guaranteed Income Supplement and the Canada Child Tax Benefit. Moreover, an individual may provide funds to their spouse or common-law partner for investment in a TFSA, with TFSA assets generally transferrable to a spouse or common-law partner upon death.

C. Canadian Tax Classification and Treatment

While the TFSA, along with the Canadian registered retirement savings plan (RRSP) constitutes the predominant tax-preferred savings accounts available for Canadians' personal savings, the two are not subject to the same Canadian tax treatment. The RRSP is an example of a tax-deferred savings plan, [118] such that contributions are made with pre-tax cash, and withdrawals are generally fully taxable. On the other hand, the TFSA is an example of a trust that is not taxable in Canada because it is essentially a tax-prepaid savings plan.[119] Contributions to a TFSA are made with after-tax cash[120], and generally, there are no Canadian tax consequences when an amount is contributed to such trust unless it carries on one or more businesses or holds one or more properties that are nonqualified investments.[121]. Withdrawals from a TFSA are also tax-free and the entire amount withdrawn can be re-contributed to the TFSA in future years.

With both RRSP and TFSA plans, income earned in the plan is not taxed (although, in the case of an RRSP, such income is taxed in the year of withdrawal).[122]

Due to the tax advantaged nature of the TFSA, all contribution, accruals and distributions are closely tracked by the Canadian Revenue Agency ("CRA"). First, a Canadian social insurance number ("SIN") must be provided by any Canadian resident opening a TFSA; second, the issuers[123] of a TFSA are required to report all TFSA to the CRA during the tax year in which contributions are made. Third, invalid contributions made to the TFSA during a year are subject to a monthly penalty tax that is a percentage of the highest excess contribution amount. Invalid contributions are contributions in excess of the annual contribution amount; or contributions made a non-Canadian resident. The penalty taxes can be applied concurrently if both types of invalid contributions take place. The tax is paid and reported to the CRA on Form RC243, *Tax Free Savings Account (TFSA) Return.*[124]

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[118] Leslie Berger, Jonathan Farrar, and Lu Zhang, "An Empirical Analysis of the Displacement Effect of TFSAs on RRSPs" (2019) 67:2 *Canadian Tax Journal* 309-33. https://taxfind.ca/#/document/2019_ctj_paper_2_309

[119] Id.

[120] The amounts contributed to a TFSA are post-tax monies and have been previously subject to Canadian tax at applicable marginal federal tax rates pursuant to Canada's graduate tax rate system.

[121] See, Section 146.2(6) of the ITA.

[122] Leslie Berger, Jonathan Farrar, and Lu Zhang, "An Empirical Analysis of the Displacement Effect of TFSAs on RRSPs" (2019) 67:2 *Canadian Tax Journal* 309-33. https://taxfind.ca/#/document/2019_ctj_paper_2_309

[123] Issuers would include trust companies, licensed annuities providers, a person who is or would be eligible to become a member of the Canadian Payments Association or a credit union in which an individual has a qualifying arrangement under the Act. See from https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/rc4466/tax-free-savings-account-tfsa-guide-individuals.html#portion_withdrawal

[124] See, https://www.canada.ca/en/revenue-agency/services/forms-publications/forms/rc243.html (site visited April 12, 2022).

In recent years, the rampant popularity of TFSAs has made it the focus of CRA attempts to curb its use by penalizing gains made through stocks held in a TFSA.[125] Such attempts, representing the CRA effort to crackdown on similar accounts throughout Canada has uncovered apparently $110 million (USD 83.75 million) in unpaid taxes.[126]

D. US Tax Classification and Treatment

TFSAs have to date been excluded from all previously issued guidance which have exempted U.S. individuals with interests in Canadian registered plans such as RRSPs, RRIFs, RESPs and RDSPs from foreign trust reporting requirements. Absent explicit guidance, there is currently no uniformity in the tax classification and reporting of TFSAs among tax practitioners. This breeds inadvertent non-compliance among U.S. individuals with TFSAs who rely on their US and Canadian tax practitioners and tax return preparers to accurately report their interests in a TFSA. Cross-border tax practitioners either report the TFSA as a foreign grantor trust or not at all because of the onerous US statutory filing requirements for such trusts, a situation that has been pointed out in several submissions to Treasury by different interests groups and associations over the years.[127] Indeed, regardless of whether a TFSA is considered a foreign financial account subject to Form 8938 or FBAR[128] disclosure or a foreign grantor trust subject to Form 3520-A, a U.S person who is a Canadian resident who contributes to a TFSA is subject to income taxation on the income of such TFSA each year. In addition, if the TFSA owns Canadian mutual funds, the U.S. person would be subject to adverse PFIC tax and reporting requirements not just limited to Form 8621.[129]

To a large extent, a TFSA is very similar to the Roth individual retirement account (IRA). in the same way that an RRSP is similar to a traditional IRA. While Canadian scholars have noted similarities [130] between both the TFSA and Roth IRA not just on purpose but on several key characteristics the two are not identical. Specifically:

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[125] *See*, Canadian Western Trust Company As Trustee of the Fareed Ahamed TFSA v. The Queen, 2019 T.C.C. 121 (May 15, 2019).

[126] See, James Munson, *Agency Memo Focus of Canadian Tax -Free Accounts Case (Corrected)*, BNA Daily Tax Report October 22, 2020 (Updated October 27, 2020).

[127] *See for example,* Jim Yager on behalf of the American Chamber of Commerce in Canada, Letter to the Hon. Mark Mazur, Asst. Secretary (Tax Policy) Dept. of the Treasury and Hon. Robert Stack, Deputy Asst. Secretary (International Affairs) Dept. of the Treasury dated March 16, 2016, Proposed Tax Relief for Various United States and Canadian Equivalent Purpose Deferred Tax Savings Plans in 16 TXC (Issue No. 51, March 16, 2016).

[128] See, IRS Background Document, "*Reporting Foreign Financial Accounts on the Electronic FBAR*", Question 6 in 14 TXC (issue No. 108, June 5, 204).

[129] See Robert E. Ward Esq., 2012 Offshore Voluntary Disclosure Program: Issues and Opportunities, 41 TMIJ 548 (Issue No. 10, October 12, 2012).

[130] Leslie Berger, Jonathan Farrar, and Lu Zhang, "An Empirical Analysis of the Displacement Effect of TFSAs on RRSPs" (2019) 67:2 *Canadian Tax Journal* 309-33. https://taxfind.ca/#/document/2019_ctj_paper_2_309; See also, Jim Yager on behalf of the American Chamber of Commerce in Canada, Letter to the Hon. Mark Mazur, Asst. Secretary (Tax Policy) Dept. of the Treasury and Hon. Robert Stack, Deputy Asst. Secretary (International Affairs) Dept. of the Treasury dated March 16, 2016, *Proposed Tax Relief for Various United States and Canadian Equivalent Purpose Deferred Tax Savings Plans* in 16 TXC (Issue No. 51, March 16, 2016); and AICPA Comments on Double Taxation Relief to U.S., Canadian Citizens with Cross-Border Savings Accounts in 16 TXC (Issue No. 45, March 8, 2016)..

- Both the TFSA and the Roth IRA are funded with post-tax monies. There is no personal tax deduction afforded to taxpayers who open accounts;
- Funds in a TFSA and Roth IRA generally grow tax-free (assuming Roth IRA guidelines are followed) nd are generally not subject to tax on distribution after retirement.
- Annual contribution limits to a TFSA and Roth IRA are fixed at $6,000 (TFSA) and $6,000 or $7,000[131] (Roth IRA) for 2022 subject to inflation and are increased for taxpayers aged 50 and above; however, unlike a TFSA (which has an annual contribution room comprised of the annual contribution limit and any unused prior year contributions), unused contribution limits in a Roth IRA cannot be carried forward to future years.
- The account holder can direct how investments in a Roth IRA or TFSA are made; also amounts in a Roth IRA or TFSA can be contributed towards a spouse or common-law partner's TFSA without any earnings accrued in such contribution being attributed back to the contributor (generally no attribution).
- There is no limit on the amount that is eligible for rollover to a Roth IRA or TFSA;
- Higher income taxpayers have their annual contributions to a Roth IRA reduced or eliminated if their modified adjusted gross income (MAGI) exceeds certain thresholds [132]each year; a TFSA does not have any income threshold.
- Unlike a TFSA where withdrawals can be made at any time, early pre-retirement distributions from a Roth IRA that are not "qualified distributions" are subject to a tax plus a 10 percent penalty on any portion attributable to the account earnings.[133]

E. US-CANADA TAX TREATY[134]

1. *Article 18*

Article XVIII (1) of the Tax Treaty generally provides that pensions arising in Canada and paid to a resident of the United States may be taxed in the United States but the amount of any such pension that would be excluded from taxable income in Canada if the recipient were a Canadian resident would be exempt from U.S. taxation.[135] For this purpose, Article XVIII(3)(a) defines "pension" as including "…any payment under a superannuation, pension or other retirement arrangement."[136]

The U.S. Treasury Technical Explanation explains that Article 9 of the 1995 Protocol amended Article XVIII (Pensions and Annuities) of the Tax Treaty. Specifically, the present definition of "pension" under Article XVIII (3) was amended by substituting the phrase "other retirement arrangement" for the phrase "retirement plan". Treasury elaborated that:

> The purpose for the change is to clarify that the definition of "pensions" includes for example, Registered Retirement Savings Plans (RRSPs) and Registered

[131] Applies to individuals aged 50 years or older as Catch Up contributions.

[132] For 2022, the income must be below $129,000 for single filers or $204,000 for married filing jointly filers. Roth IRA contributes are entirely phased out once the income reaches $144,000 for single filers and $214,000 for married filing joint.

[133] See IRS Publication 590-B (2020), *Distributions from Individual Retirement Accounts (IRAs)*

[134] Supra at 4

[135] *See* Article XVIII (1).

[136] *See* Article XVIII(3)(a).

> Retirement Income Funds ("RRIFs") in Canada, as well as other amounts paid by other retirement plans or arrangements whether or not they are qualified plans under US domestic law; this would include, for example, plans and arrangements described in section 457 or 414(d) of the Internal Revenue Code.

The U.S. Joint Committee on Taxation ("JCT") further commented:[137]

> (9) The existing treaty has a provision limiting source-country taxation of pensions. Article 9(1) of the proposed protocol makes a slight change in the definition of the term "pensions." The protocol clarifies that the definition of pensions includes, for example, payments from a U.S. individual retirement account (an "IRA"), and provides that the definition of pension includes, for example, payments from a Canadian registered retirement savings plan (a "RRSP") or registered retirement income fund (a "RRIF").

Although a Roth IRA which is explicitly considered a pension for purposes of the Treaty under Article XVIII(3)(b)) would not be subject to Canadian taxation under the Treaty, this protection no longer applies when the owner of a Roth IRA migrates to Canada and becomes a Canadian tax resident. Under such circumstances, the Treaty makes clear that any subsequent contributions to the Roth IRA (including conversions or rollovers from a qualified employer plan account) will cause the ROTH IRA to lose its treaty protection. Thereafter, all growth accrued in the Roth IRA account would be subject to full Canadian taxation for as long as the person is a resident of Canada. Future distributions in excess of the account balance on date of the disqualifying contribution are also subject to Canadian tax while resident in Canada. Assets in the ROTH IRA are subject to Canadian deemed disposition rules when the person terminates his or her Canadian residence to the extent the appreciation in the Roth IRA related to the contribution on behalf of a resident.

Unlike a Roth IRA, a Canadian TFSA is not afforded treatment as a pension under Article XVIII (3) of the Treaty. Nonetheless, to be treated qualify as a pension under the Treaty, it must constitute an "other retirement arrangement" under Article XVIII(3)(a) of the Treaty. To do so, the TFSA must be a retirement arrangement that is not an RRSP, RRIF or a qualified plan under Code § 401(a) or Code §§ 457 or 414(d) of U.S. domestic tax law,[138]. We believe that it would qualify as an "other retirement arrangement" because, like the Roth IRA in the US, it is considered among that class of retirement or other employee benefit arrangements favored under Canadian tax laws. Indeed, the JCT noted as follows:[139]

> In addition, under present law, certain Canadian retirement plans that are qualified plans for Canadian tax purposes do not meet U.S. internal law requirements of qualification. The existing treaty, however, permits a U.S. taxpayer who is a

[137] Joint Committee on Taxation, Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada (JCS-15-95), May 23, 1995.

[138] See also U.S. Treasury Technical Explanation to the 2007 Protocol, stating: "*In addition, a Canadian retirement compensation arrangement (RCA) is not a qualifying retirement plan because it is not considered to be generally exempt from income taxation in Canada*."

[139] Supra at 63

> beneficiary of an RRSP to obtain U.S. tax deferral corresponding to the deferral that the RRSP provides under Canadian tax law, to the extent that income is reasonably attributable to contributions made to the plan by the beneficiary while he was a Canadian resident (see Rev. Proc. 89-45, 1989-2 C.B. 872). **The proposed protocol expands the class of retirement or other employee benefit arrangements favored by Canadian law with respect to which the United States will grant corresponding deferral of U.S. tax and provides that Canada will provide reciprocal treatment to a Canadian taxpayer who is a beneficiary under a pension plan or other arrangement that qualifies for deferral of U.S. tax under U.S. law. (Emphasis added).**

The above quote confirms that the term "pension" under Article XVIII(3)(a) was expanded to include other retirement plan or arrangements that received favourable treatment under Canadian law that would not satisfy qualified plan treatment under U.S. laws. A TFSA is afforded favourable treatment under Canadian law. However, although it is essentially a trust account for retirement savings, it would not be included as part of the class or category of retirement plans that would be afforded "qualifying plan" treatment in Canada for purposes of Article XVIII because it can be created without any employer involvement.[140] The term "qualifying plan" under Par. 15 of Article XVIII is limited to:

> …a trust, company organization or other arrangement that, (a) is a resident of that State, generally exempt from income taxation in that State and operated primarily to provide pension or retirement benefits; (b) is not an individual arrangement in respect of which the individual's employer has no involvement; and (c) the competent authority of the other Contracting State agrees generally corresponds to a pension or retirement plan established in and recognized for tax purposes in that State. Thus, U.S. individual retirement accounts (IRAs) and Canadian registered retirement plans (RRSPs) are not treated as qualifying retirement plans unless addressed in ….

In light of the above analysis, we would likely conclude that the TFSA, would not qualify as a "pension" under Article XVIII(3)(a) of the Treaty. However, we would challenge this conclusion in light of the fact that the Treaty treats a ROTH IRA as a pension, notwithstanding that it also an individual arrangement that takes place without employer involvement. Pursuant to Article XVIII(3)(b):

> *"The term "pensions" also includes a Roth IRA, within the meaning of section 408A of the Internal Revenue Code, or a plan or arrangement created pursuant to legislation enacted by [the US or Canada] after September 21, 2007, that the competent authorities have agreed is similar thereto. Notwithstanding the provisions of the preceding sentence, from such time that contributions have been made to the Roth IRA or similar plan or arrangement, by or for the benefit of a resident of [Canada] (other than rollover contributions from a Roth IRA or similar plan or arrangement described in the previous sentence that is a pension within the meaning of this subparagraph), to the extent of accretions from such*

[140] *See* Tax Treaty, Article XVIII (8) through (14) and (15).

> *time, such Roth IRA or similar plan or arrangement shall cease to be considered a pension for purposes of the provisions of this Article." [redacted for clarity, emphasis added]*

Effectively, Roth IRAs are treated as pensions under the Treaty, notwithstanding that it would not qualify under Article XVIII(3)(a), and payments from the US to Canadian residents from Roth IRAs are tax-free in Canada because such distributions are tax-free in the U.S. There is the caveat that if contributions are made to a Roth IRA for the benefit of a Canadian resident while resident, then any related amounts (distributions and income therefrom) will not be deemed to be pensions for the purposes of Article XVIII (3), and therefore may be taxed in Canada.

As TSFAs were not introduced by Canadian legislation until after the Fifth Protocol was signed in 2007, it is not mentioned explicitly in Article XVIII of the Treaty. However, it seems fairly obvious that the Protocol was negotiated in light of the potential for Canada to establish a Roth-IRA-like structure and for the two Competent Authorities to come to an agreement on this issue. While there are many notable similarities between a Roth IRA and a TFSA which cannot be ignored, the two are not identical. Nonetheless, the question must be raised as to why a TFSA is not protected under the Treaty in the same way that a Roth IRA is.

We suggest that the difference in treatment of the Roth IRA and TFSA under the Treaty is attributable to the fact that the TSFA allows for considerably more freedom with regard to withdrawals and contributions are not restricted by income level like a Roth IRA. Moreover, section 146.2 of the Act deems a TSFA not to be a retirement savings plan for Canadian tax purposes. It would therefore be somewhat inconsistent for the CRA to request the U.S. Competent authority to recognize something as a "pension" for the purposes of the Treaty when Canadian domestic law clearly states it is not.

Article XVIII (7) of the Treaty provides an alternative basis for extending treaty protection to a TFSA. It reads:

> *7. A natural person who is a citizen or resident of a Contracting State and a beneficiary of a trust, company, organization or other arrangement that is a resident of the other Contracting State, generally exempt from income taxation in that other State and operated exclusively to provide pension or employee benefits may elect to defer taxation in the first-mentioned State, subject to rules established by the competent authority of that State, with respect to any income accrued in the plan but not distributed by the plan, until such time as and to the extent that a distribution is made from the plan or any plan substituted therefor…*

Paragraph 7 of Article XVIII was originally added to the Treaty by the Third Protocol in 1995 (although its language was tweaked in the Fifth Protocol in 2007). Prior to that time the opportunity to elect to defer taxation was limited to RRSP accounts. Paragraph 7 was added to extend the scope of elective deferral to pensions and employee plans. The Technical Explanation to the Third Protocol explains the scope of the extension of Treaty benefits:

"*As amended, paragraph 7 applies to an individual who is a citizen or resident of a Contracting State and a beneficiary of a trust, company, organization, or other arrangement that is a resident of the other Contracting State and that is both generally exempt from income taxation in its state of residence and is operated exclusively to provide pension, retirement, or employee benefits.*" [141]

Based on the above, a US person who is a Canadian resident with a TFSA should be able to elect tax deferral on the income realized from TFSA asset investments if the following conditions are met:

1. Such individual is a beneficiary of the "Plan";
2. The Plan is income tax exempt under Canadian law; and
3. The Plan is operated exclusively to provide "pension, retirement or employee benefits."

The TFSA would meet all three of the above conditions. First, the US individual aka holder of the TFSA would be a beneficiary of the "plan". Second, the TFSA investment earnings and distributions are not subject to Canadian taxation. Third, although the TFSA does not exclusively provide pension or employee benefits, it is intended to provide retirement savings as distributions would only be tax-free if received by a Canadian resident individual on or after retirement age. The fact that Canadian tax law itself does not deem a TFSA as a retirement plan under the Act (but rather as a trust under subsection 146.2 of the Act) should not deter the IRS from extending similar deferral opportunities for the TFSA for US tax purposes as has been afforded to Roth IRAs for Canadian tax purposes.

2. *Article XXII (2): Classification as Income from a Trust*

While the TFSA does not meet the Treaty definition of pension under Article XVIII, it would alternatively qualify as a Canadian resident trust under Article XXII of the Tax Treaty. Specifically, Article XXII (2) of the Tax Treaty provides:

> (3) Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State, except that if such income arises in the other Contracting State, it may also be taxed in that Other State.
> (4) To the extent that income distributed by an estate or trust is subject to the provisions of paragraph (1), then, notwithstanding such provisions, income distributed by an estate or trust which is a resident of a Contracting State to a resident of the Other Contracting State who is a beneficiary of the estate or trust may be taxed in the first-mentioned State and according to the laws of that State, but the tax so charged shall not exceed 15 percent of the gross amount of the income; provided however, that such income shall be exempt from tax in the first-mentioned State to the extent of any amount distributed out of income arising outside that State.

[141] Treasury Department, Technical Explanation of the Protocol Amending the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, June 13, 1995.

If the TFSA distributions were treated as a payment out of a trust rather than a pension, and further, as income from the trust rather than capital,[142] then such amounts would be subject to 15 percent withholding tax as income distributed from a Canadian resident trust to a U.S. individual resident of the United States, regardless of periodic or lump-sum payments under Article XXII of the Tax Treaty which addresses "other income"[143]. However, since Canadian domestic tax law does not generally tax distributions from an TFSA, we do not think Article XXII would apply.

V. RECOMMENDATIONS

Based on the foregoing analysis of TFSAs and RCAs, we would recommend that the Treasury and IRS provide administrative guidance instructing tax practitioners to report:

1. TFSAs as foreign grantor trusts that are not subject to annual foreign trust reporting requirements as the administrative burdens posed by such foreign trusts on IRS resources far outweigh the benefits generated from IRS enforcement efforts directed at delinquent foreign trust filings with respect to US beneficial interests. Indeed, such assets are low-balance depositary accounts that would be an unlikely offshore vehicle for US tax avoidance by US persons resident in Canada and already subject to government oversight and reporting requirements in Canada. However, distributions to USP resident beneficiaries of TFSAs should be subject to foreign trust reporting by filing Form 3520; and

2. RCAs as foreign non-grantor trusts similar to a Code §402(b) non-exempt employees trusts that would be exempt from Form 3520 reporting until distributions from the RCA are received by a USP Athlete who is a beneficiary of an RCA Trust. Consequently, distributions from the RCA Trust to the USP Athlete would be subject to U.S. tax under Code §72 with contributions and earnings accumulated in the RCA Trust prior to attaining U.S. tax residency also subject to U.S. tax under Code §§72(w)(2) and (w)(3).

Revenue Procedure 2020-17 in its current versions would not be applicable to an RCA or TFSA, and therefore this area of cross-border tax reporting of trusts that are foreign retirement or savings plans are prone to inconsistent and incorrect foreign trust reporting positions which create further complexity for US taxpayers with beneficial interests in these types of Canadian retirement and savings plans. The costly financial consequence of delinquent Form 3520/3520-A filings on US taxpayers with beneficial interests in TFSAs and RCAs are in addition to the existing compliance burden on taxpayers subject to duplicative reporting under FBAR and FATCA for

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[142] Since the reduced rate of 15 percent applies to "income," and not the distribution of "capital" i.e., the employer contribution. See ITA 212(1)(c) also only applies to "income" of the trust that is income with reference to ITA 104(13).

[143] It has been acknowledged by Canadian practitioners that the inclusion of RCAs as "pension" under the Treaty when there is no definition of "pension" under the Treaty results in anomalous results because only periodic payments an RCA can qualify as a "pension" under Article XVIII (2) while lump-sum payments do not. See David W. Ross, RCAs- Withholding Taxes on Retirement Compensation Arrangements, *Taxation of Executive Compensation and Retirement Journal*, Volume XX No. 4 (2009-01-01) commenting on CRA Technical Interpretation 9503510(E).

such assets. Indeed, the National Taxpayer Advocate noted:

> *The IRS has exercised its regulatory authority to eliminate duplicative reporting of assets on Form 8938 if the assets are reported or reflected on certain other timely filed international information returns (e.g., Forms 3520,3520-A, 5471, 8621, 8865, or 8891)… [redacted for clarity, emphasis added]*[144]

Effectively, TFSAs and RCAs would be already subject to foreign financial reporting under FATCA and FBAR. There is no further need to exacerbate the annual international information reporting and toll IRS resources by requiring that TFSAS and RCAs be subject to Form 3520/Form 35290-A reporting as foreign trusts when no withdrawals or distributions subject to U.S. tax have been made to the US beneficiary. Both types of Canadian plans are already subject to annual Canadian filings and, in the case of the RCA, substantial Canadian taxes. These are not the type of foreign trusts that the IRS should be expending its resources on.

[144] *See* National Taxpayer Advocate 2022 Purple Book: Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration (released December 31, 2021) available at ARC21_PurpleBook.pdf (irs.gov) .