

FOREIGN PENSION PLANS FOR RESIDENTS OF CANADA
By Gaelen Fisher, B.Comm, MBA, CMA, CGA

Recently, I received a call from a practitioner asking about the 5th Protocol to the Canada-US Tax Treaty and its effective date for 401K recognition in Canada as a pension contribution. The caller mentioned that a respected publication he read stated that foreign pensions would be recognized effective January 1st, 2008. **Competent Authority (CA)** in Ottawa has confirmed that this Article is effective **January 1, 2009**, the year following the signing of the Agreement by the former President Bush. That said . nothing is ever that clear.

Canadian residents are taxed on their world income constructively received. This test can be set aside by the operation of a tax treaty or by CRA policy and interpretation. With the change in the Treaty to recognize 401K contributions as an allowable pension contribution one should expect a concurrent change in policy.

There is a test case on the issue of the treatment of 401Ks in Canada at Competent Authority. It has been there for over two years. The sole precedent is at the Tax Court level under the informal procedure and the taxpayer represented himself and argued only part of the issue. The taxpayer argued deductibility which is not the essence of the problem as employee contributions are exempt income in the USA. In other words, the US W2 slips consider the employee contributions as deferred income and taxable wages are accordingly reduced at the Gross Wages line. For Canada to tax employee contributions, CRA must take an assessment action to add the contributions to income on the T1 return. It is this step that should be challenged. The taxpayer should have challenged this inclusion in his income. No one gets a deduction for pension contributions in the USA on a 1040. This is a unique Canadian approach.

Here's the problem with CRA's past treatment of 401K contributions:

- 1) Contributions by the **employee** are considered contributions to an employee benefit plan, while
- 2) Contributions by the **employer** are considered contributions to a pension plan.

This dual standard has no basis in Canadian law. Further, the IRS Code clearly states that a 401K is a pension plan and, with the current economic conditions, 401Ks are sadly becoming the standard with many large US companies. 401Ks are typically under-funded according to FRONTLINE® (<http://www.dptv.org/news/frontline/retire.shtml>). Should this case go to Canadian Federal Court, there is a significant likelihood that the CRA position would not be upheld. What then?

Whether the matter is decided by a court of competent jurisdiction or through the operation of the 5th Protocol to the Canada-US Tax Treaty, the results will essentially be the same. Transitional provisions are needed.

Related Issue – What happens when commuters retire?

One on-going related matter is for CRA to determine how much money will be non-taxable when Canadian residents begin to receive their 401K retirement pensions. This problem is created by the fact that, from the late 1990s to 2008, taxpayers were taxed in Canada on their contributions to a 401K. However, in the USA, contributions were exempt. The matter needs to be dealt with now by the Government of Canada. This is generally called the mismatch of foreign tax credit problem and arises from the different rules used in Canada and the USA for the timing of the recognition of income. Compounding the problem is the lack of carryforwards for employees' foreign tax credits in Canada.