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Memo

Date: February 7, 2016

Re: U.S. Citizens in Receipt of U.S. Pension Income While Resident in Canada

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References: Canada U.S. Income Tax Convention, 1980, (the Treaty)

- Article XVIII – Pensions and Annuities
- Article XXIV – Elimination of Double Taxation
- Article XXIX – Miscellaneous Rules

Pensions and Annuities:

The Treaty identifies pensions and annuities to include all nature of pension payments, including those from U.S. IRA, 401(k), Roth accounts, as well as employer pensions and social security benefits. This memo is restricted to a discussion of the treatment of IRA and similar pensions paid to U.S. citizens resident in Canada.

Article XVIII of the Treaty sets the framework for the taxation of pension income:

(1) States that pensions arising in one country may be taxed in the other country, but the amount which is exempt from taxation in the country of payment will also be exempt in the second country; and

(2) Where the country in which the payment originates also imposes a tax, that tax is limited to 15% of the gross taxable pension.

However, Article XXIX(2) states that nothing contained in the Treaty shall affect the right of the United States to tax its citizens, except as specifically noted in Article XXIX(3). This Article has been referred to as the "notwithstanding clause", since it negates all of the provisions contained in the Treaty, except those specifically exempted. Since Article XXIX(3) does not mention Article XVIII(2) specifically, its provisions are not applicable to United States citizens, and therefore there is no limit on the tax rate applied to pension income.

The limitation on the rate of tax which may be imposed in the United States, therefore, is limited to 15% only where the payment is made to a non resident non citizen of the United States. Accordingly, if a non U.S. citizen resident in Canada is receives a taxable pension from U.S. sources, the withholding tax imposed in the United States is limited to 15%.

Taxation of Foreign Pension Income in Canada:

A resident of Canada is taxable in Canada on world income, including pension income received from U.S. sources, subject to the operation of the Treaty.

Canada applies the provisions of the Treaty in allowing a foreign tax credit to residents of Canada, but limits the allowable foreign tax credit to the rate set out in Article XVIII(2), or 15%. This position has been before the courts in Canada, and has been upheld in Meyer v. The Queen, 2004 DTC 2393, where the Tax Court of Canada ruled that a resident of Canada who paid more than 15% tax in the U.S. was not entitled to a higher foreign tax credit in Canada, since that additional tax would be considered to have been gratuitously paid. In its decision, the Tax Court relied on Treaty Article XXIV (4) which states:

> "4. Where a United States citizen is a resident of Canada, the following rules shall apply: (a) Canada shall allow a deduction from the Canadian tax in respect of income tax paid or accrued to the United States in respect of profits, income or gains which arise (within the meaning of paragraph 3) in the United States, except that such deduction need not exceed the amount of the tax that would be paid to the United States if the resident were not a United States citizen;" (underlining added)

This position therefore works well for a non U.S. citizen, since the allowable foreign tax credit in Canada is the same as the maximum allowable tax which is withheld in the United States.

Taxation of U.S. Citizens:

United States citizens are taxable in the U.S. on world income regardless of whether they reside in the U.S. or not. Accordingly, in the absence of other provisions a U.S. citizen in Canada may find that the normal income tax rate applied to pension income received from U.S. sources may exceed 15% (depending on the Taxpayer's taxable income). Since Canada is not obligated to allow a foreign tax credit for the amount of tax in excess of 15% paid in the U.S., and since the pension is from U.S. sources, a foreign tax credit would not be available in the U.S. for the additional tax paid in Canada., and there is a potential for double taxation in that the amount of tax on pension income in excess of 15% would be taxable in both Canada and the United States.

Re-Sourcing of Pension Income:

In order to address this problem and to prevent double taxation Article XXIV addresses this problem in two areas:

XXIV (4)(b) allows for the deduction from U.S. tax of an additional credit for the amount of tax on pension income which exceeds the allowed 15% in Canada:

> "(b) For the purposes of computing the United States tax, the United States shall allow as a credit against United States tax the income tax paid or accrued to Canada after the deduction referred to in subparagraph (a). The credit so allowed shall not reduce that portion of the United States tax that is deductible from Canadian tax in accordance with subparagraph (a)."

The mechanism for the application of this credit is dealt with in Article XXIV(6), which permits the re-sourcing of pension income which arises within the United States to deem it to have arisen in Canada:

> "6. Where a United States citizen is a resident of Canada, items of income referred to in paragraph 4 or 5 shall, notwithstanding the provisions of paragraph 3, be deemed to arise in Canada to the extent necessary to avoid the double taxation of such income under paragraph 4(b) or paragraph 5(c)."

From a practical perspective, then, pension income arising in the U.S. is deemed to have arisen in Canada, and the amount of tax paid in Canada which exceeds the 15% foreign tax credit allowed in Canada is allowed to be claimed on form 1116 accompanying a U.S. income tax return, subject to the usual limitations applied to foreign tax credits.