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ROTH IRAs IN CANADA

The gift that keeps on giving. How $250,000 can turn into $35 million **TAX FREE** to an heir

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OVERVIEW

Given the recent tax changes implemented in the US, this may be the time for not only keeping an IRA, but in some cases doing a Roth **conversion** before returning or immigrating to Canada. As with most cross-border wealth planning issues, individual situations can be complex and we recommend seeking professional advice before implementing any plan.

We are going to discuss some key benefits of both a regular IRA and Roth IRA for Canadians, and show how it can be a useful estate planning tool for families regardless of the owner or beneficiary's residency. We will analyze the costs and benefits during both the original owner and beneficiary's lifetime. Basically, **if you do not require your entire IRA/Roth IRA for your retirement please keep reading.**

IRAs AND RRSPs

First, a quick synopsis of the IRA and Roth IRA, and how they differ from an RRSP or RRIF. These subtle differences will become important later on.

IRA (INDIVIDUAL RETIREMENT ACCOUNT)

- An IRA allows an individual to direct **pre-tax** income into an investment account (often with employer matching funds). It grows tax-deferred until funds are withdrawn in retirement (59.5yrs of age or older). This is very similar to an **RRSP**.
- Annual IRA contributions are limited to $5,500/yr or $6,500 for those over 50yrs of age.
- Generally, all of the distributions from the IRA are taxable as regular income in both the US and Canada. You must begin taking funds from an IRA in the year you turn 70.5. These are referred to as RMDs (required minimum distributions) and they increase on an annual basis as per the IRS guidelines. This is very similar to a **RRIF**.

ROTH IRA

- A ROTH IRA allows an individual to direct **after-tax** income to an investment account up to a specified amount each year. Both the earnings on the account and withdrawals after the age of 59.5 are tax free in the US and Canada due to the tax treaty. The key here is the after-tax component; all money put into a ROTH is after-tax dollars. This feature is similar to the **TFSA** account in Canada.
- Annual ROTH contribution limits range from $5,500-$6,500 per year depending on age, but eligibility to contribute is income tested. If your earned income is over $135,000 (single filer) or $199,000 (joint filer) you cannot contribute. You can, however, **convert an unlimited amount** of a traditional IRA into a ROTH IRA. This is commonly referred to as a "backdoor IRA". The amount converted will be **taxable** as regular income in the year of conversion.
- ROTH accounts are **flexible** in that **no RMDs** are required during the **original owner's lifetime**. This allows the account to compound over time.

TIME TO STRETCH OUT

Now that we have laid out the basics of the IRA and Roth IRA we will explain the key feature that both accounts have that the Canadian RRSP and RRIFs do not. It is commonly referred to as the "*stretch*" option.

In Canada, when the owner of an RRSP or RRIF dies the account can be transferred tax-free to the surviving spouse's RRSP or RRIF account. However, upon the last spouse's death, the market value of **all** combined RRSPs and RRIFs will be taxable as income in the year of death.

The **stretch** option available on IRAs and Roths not only eliminates the deemed disposition upon death, it allows for another generation of tax deferral.

- This is achieved by naming a non-spousal beneficiary. There can be one beneficiary or multiple beneficiaries of any age, American or Canadian.

- The RMDs on the inherited IRA or ROTH begin immediately and are calculated based on the beneficiary's age. Which means that for a young beneficiary, the RMDs will be very small.
- By stretching the IRA or ROTH, the investments continue to grow tax deferred (IRA) or tax free (ROTH) within the account for the lifetime of the beneficiary.

Roth IRAs have been a popular estate planning tool for affluent families in the US for decades, but there has been conflicting advice on what to do with IRAs or Roth IRAs when moving to Canada. Some Canadian advisors advocate slowly collapsing them into a RRSP due to the difficulty of trying to locate a US custodian who will hold non-resident accounts. Another solution is to find a dual-licensed cross-border advisor and keep the IRA or Roth intact.

We believe the stretch feature available to IRA and Roth IRAs are incredibly valuable for Canadian beneficiaries. The following solution **could add millions of dollars** in added benefits to Canadian heirs.

EXAMPLE

Let's look at a real-life example to demonstrate the power of both the intergenerational tax deferral and tax free distribution here in Canada.

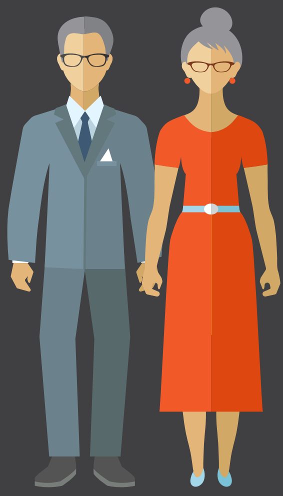
Randy (age 75) and Diane (age 70) are Canadian citizens moving back to Victoria after working 30 years in the Seattle technology sector. They have a $500,000 IRA from Randy's work along with a sizeable asset base outside of the IRA to fund their retirement comfortably.

They have two grown children; Chris (age 35) and Brad (age 32).

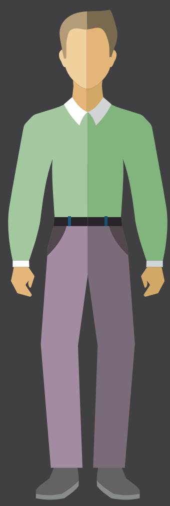
Their primary objective for the IRA is intergenerational wealth transfer. More specifically, to provide funds for their grown children to buy a first home and to fund pre- and post-secondary education for any future grandchildren. They want to know if there is anything they should consider before moving back to Canada.

KEY ASSUMPTIONS:

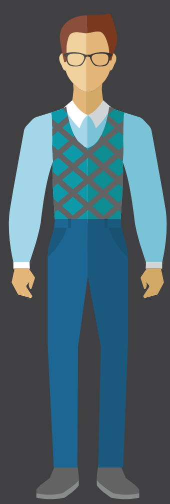
- Rate of return: 8% (100% global stocks)
- State of residence in year of ROTH conversions: Washington
- Life expectancy of beneficiaries: 82 yrs (per IRS guidelines)
- Beneficiary provincial residency: British Columbia
- RMD calculations per IRS guidelines



Randy (age 75) Diane (age 70)



Chris (age 35)

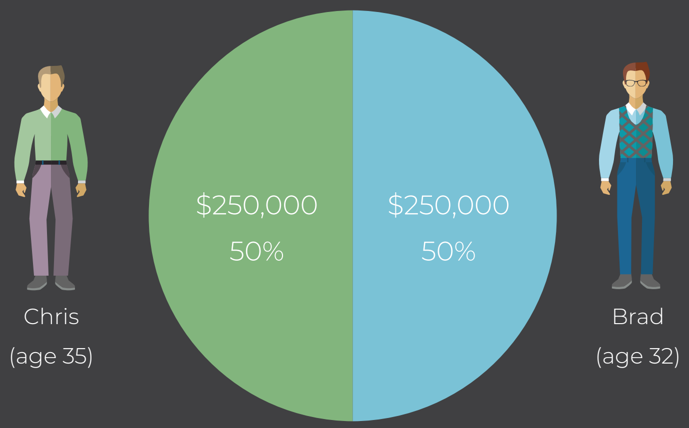


Brad (age 32)

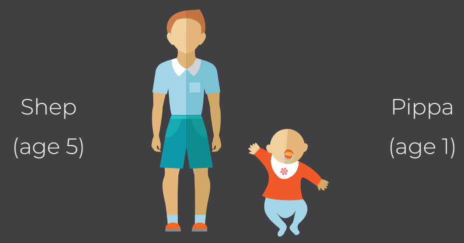
OPTION 1: SIMPLE IRA STRETCH

Name as equal beneficiaries their two adult children, Chris and Brad. This option will allow an intergenerational **tax-deferral** for their heirs spread over each of their respective lifetimes.

RANDY'S $500,000 IRA

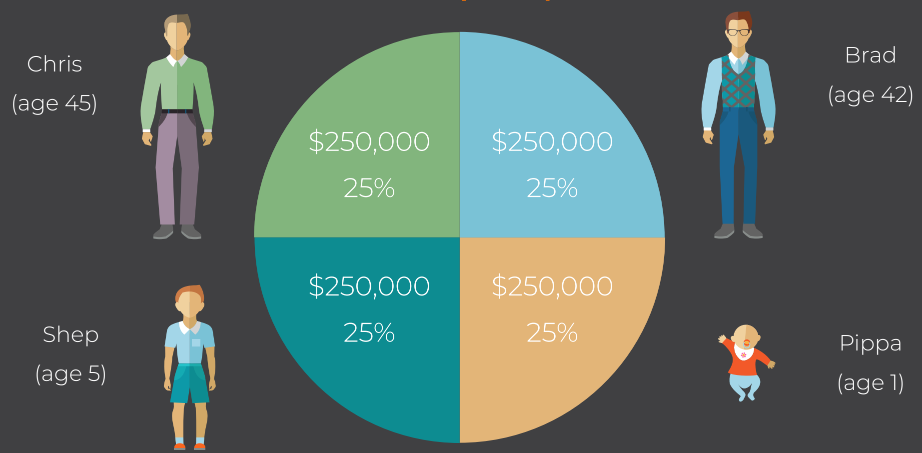


Fast forward **ten years** and with the an 8% return compounded annually, Randy's IRA has doubled in value to $1,000,000. Each of the boys had one child along the way, Shep and Pippa.

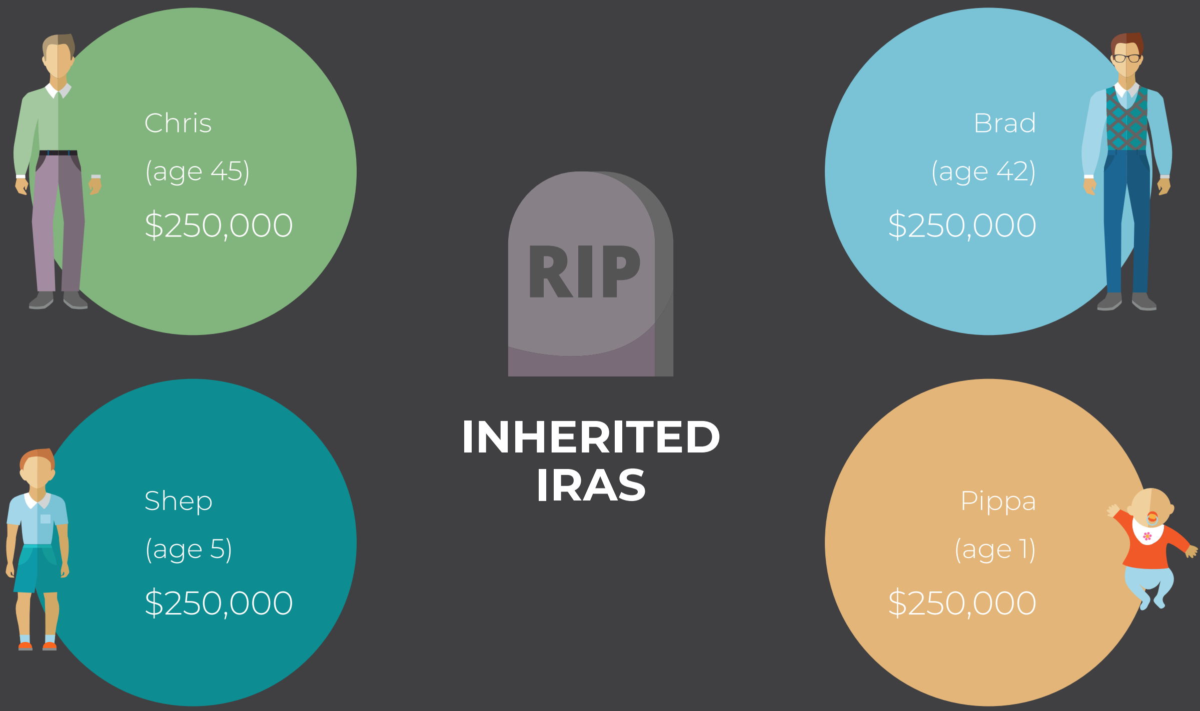


Shep and Pippa are each added as equal beneficiaries on the existing IRA (now 25% each).

RANDY'S $1,000,000 IRA



Now Randy passes away at age 85 and the assets are now split into four inherited IRAs.



Below are the estimated combined distributions of a $250,000 inherited IRA over the beneficiary's lifetime after-tax (remember, IRA distributions are fully taxable as income here in Canada).

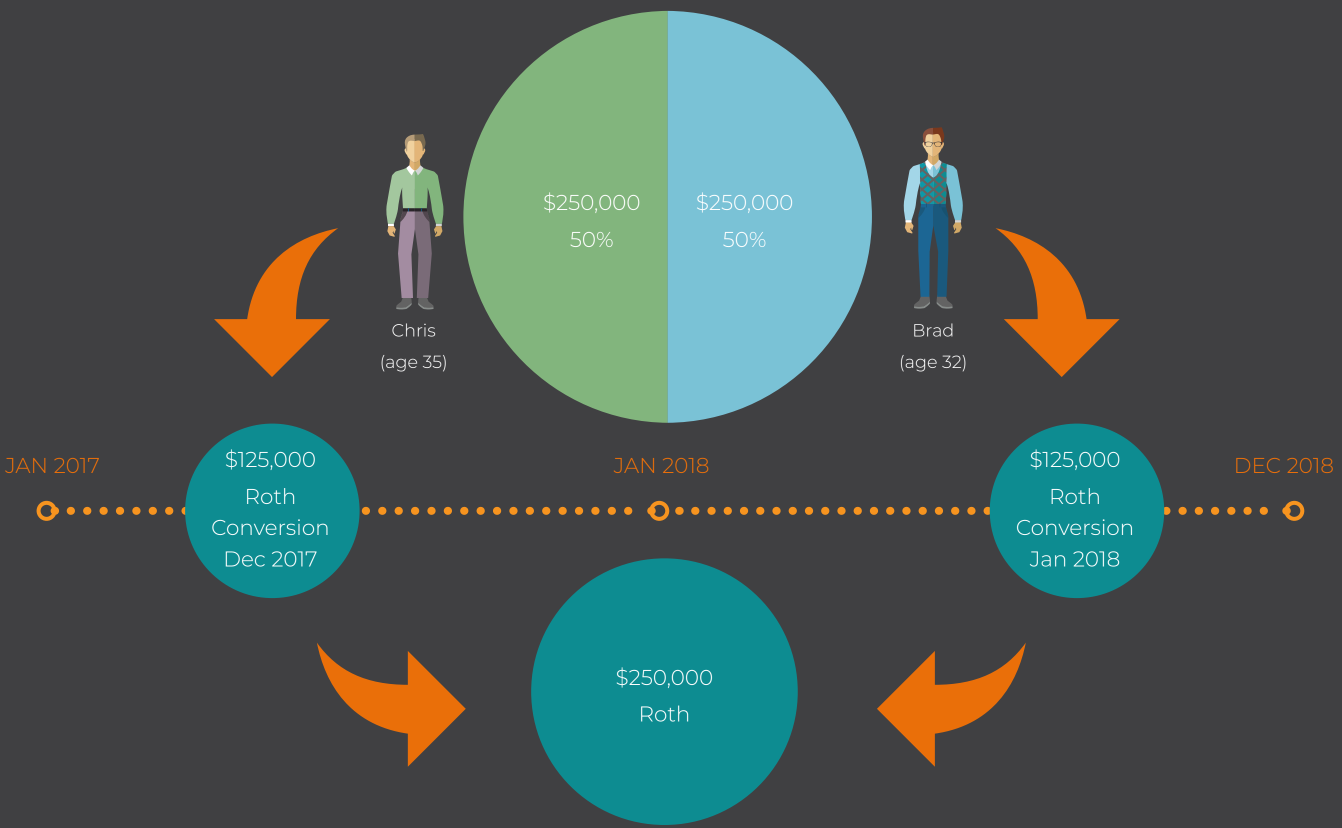
Chris (IRA)	$2.0mm
Brad (IRA)	$2.4mm
Shep (IRA)	$10.5mm
Pippa (IRA)	$12.8mm

While this is a better outcome than having an RRSP or RRIF due to the tax deferral, there is another option that could add millions in after-tax distributions.

OPTION 2: BACKDOOR ROTH CONVERSION

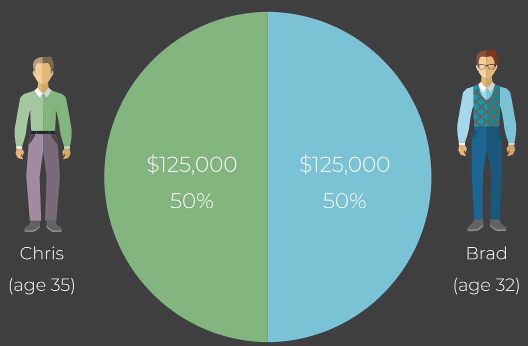
Randy makes two Roth conversions out of the original IRA of $125,000 each ($250,000 total) over the span of two calendar years post-retirement and pre-immigrating back to Canada.

RANDY'S $500,000 IRA

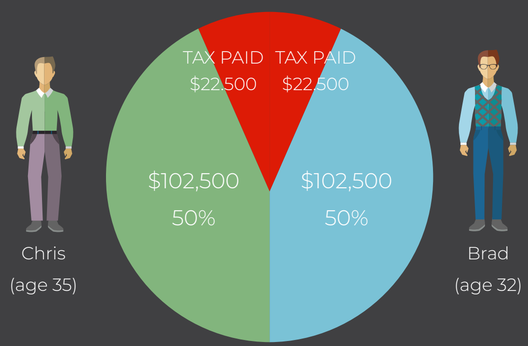


Name Chris and Brad as equal beneficiaries on the newly created Roth. These conversions will trigger ~18% tax in the US for a total of ~$45,500 ($250,000 * 18% = $45,500). To account for this tax we will reduce the Roth account accordingly ($250,000 - $45,000 = $205,000). Randy now has two IRAs. One regular IRA and one Roth each split evenly between Chris and Brad.

RANDY'S $250,000 IRA

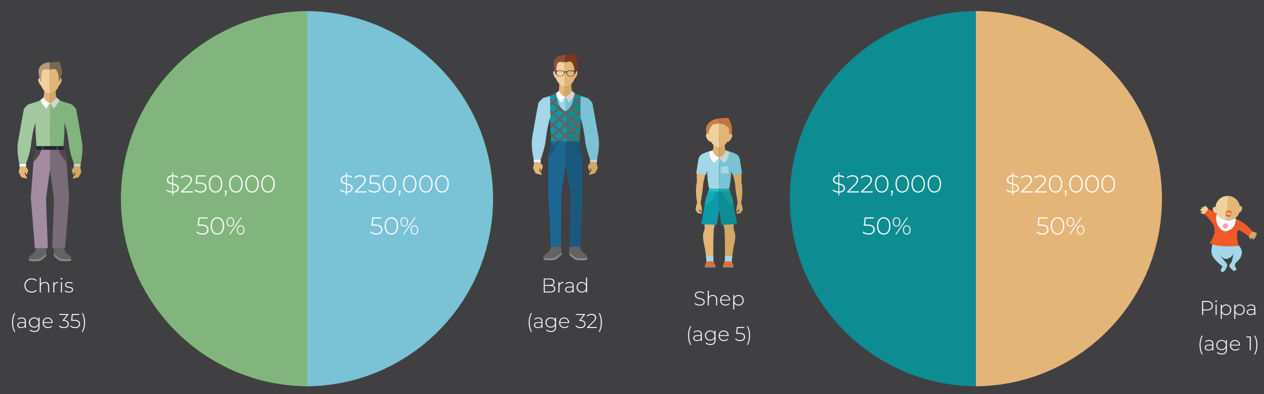


RANDY'S $205,000 Roth

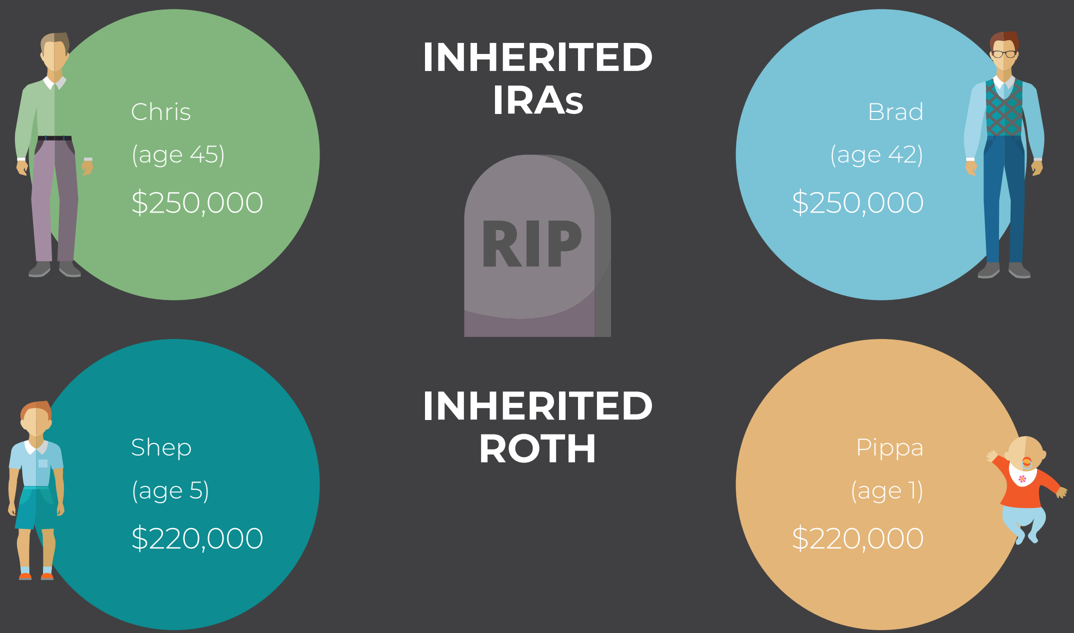


Fast forward **the same ten years** and with the an 8% return compounded annually, the two original accounts have almost doubled in value to a combined $940,000 ($500,000 IRA, $440,000 Roth). Each of the boys had one child along the way (Shep age 5, and Pippa age 1), and Shep and Pippa replace their fathers as beneficiary on the Roth only.

RANDY'S $500,000 IRA **RANDY'S $440,000 Roth**



Now Randy passes away at age 85 and the assets are now split into four inherited accounts: Two IRAs, one for Chris and one for Brad and two Roths one for Shep and one for Pippa.



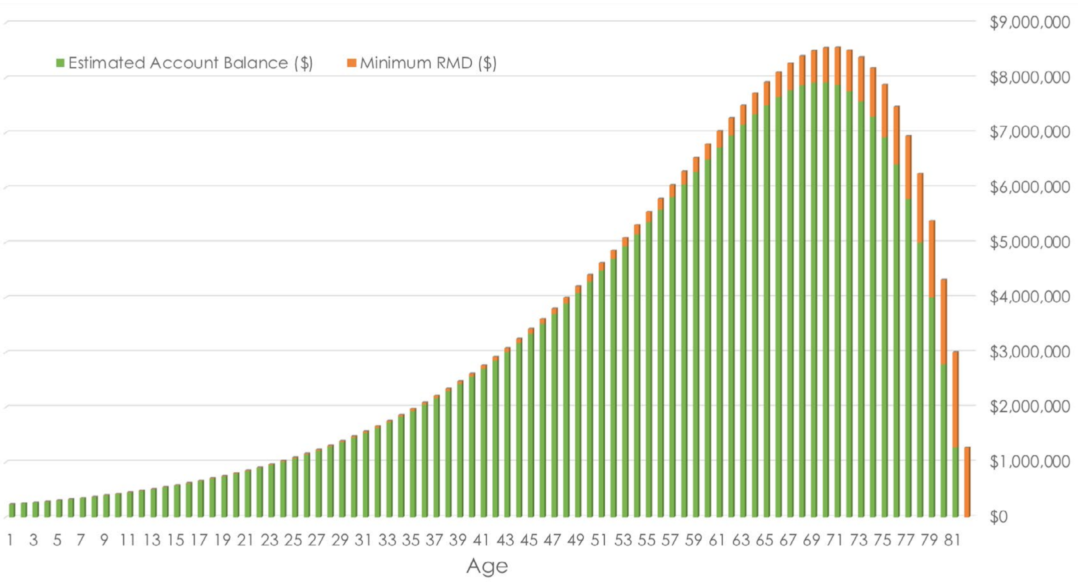
This now allows for intergenerational tax-deferral for Chris and Brad, and a **tax-free** intergenerational distribution to Shep and Pippa.

There is no change in estimated after-tax distributions for Chris or Brad, but look at the after-tax distributions for the two grandchildren:

Chris (IRA)	$2,000,000
Brad (IRA)	$2,400,000
Shep (Roth)	**$16,500,000**
Pippa (Roth)	**$21,500,000**

That is not a typo. This option makes a $6 to $9 million difference for the younger beneficiaries because of the tax-free nature of the distributions.

Randy and Diane have front-loaded a one-time tax in the US of ~18% on a $250,000 Roth conversion to forgo future tax of 50% that their grandchildren would have been subject to on those distributions here in Canada.



The compounding effect of 8% tax-free growth is stunning.

Thus, a $250,000 gift turns into over $35 million of lifetime tax-free distributions to the grandchildren.

This example is a large Roth conversion and may not be viable for most families. However, the rationale and math hold up regardless of the amount of conversion. In fact, a **$75,000 conversion looks even better** since the graduated tax rate in the US is only 15% (vs the 18% we used above). If you work with the right US custodian you can also name multiple beneficiaries of a single Roth account so you do not need to have an individual account for each grandchild. You can also add grandchildren to the account after the Roth is created **no matter where you live**. This allows you the flexibility to include new grandchildren or great grandchildren to the plan.

JUST FOR FUN...

One more thing, if stocks in the future return their long term average of 10% and not the 8% we used in this example **the lifetime tax free distributions jump to over $130,000,000.** One... hundred... thirty... million... dollars... tax... free. Thanks grandpa!

CAVEATS (THERE ALWAYS ARE CAVEATS)

There are a few things to keep in mind when doing a Roth conversion that are critical to long term success. Below are a few things you need to keep in mind when contemplating a conversion:

- The Roth must be in place a minimum of five years before taking distributions and the original account owner be over the age of 59.5.
- You must file a treaty election (form T1135) upon entering Canada declaring your Roth IRA. **You cannot make any further deposits into the Roth once you arrive in Canada**. If you do, you may forfeit the tax-free nature of the account.
- When inheriting an IRA or Roth IRA, you must have the inherited IRA open at a US custodian. Unlike IRA rollovers, you do not have a 60-day window to deposit the proceeds into a qualifying account. The proceeds of any inherited IRA must be made from custodian to custodian. If not, **its classified as a distribution and fully taxable as income in Canada in the case of an IRA.**
- For non-US resident beneficiaries, you must obtain an **ITIN** (Individual Tax Identification Number) to open the inherited IRA account. This can be done through an approved US custodian or cross-border advisor.

CONCLUSION

New lower US tax rates, combined with tax-free compounding allow for a wealth transfer unlike anything available in Canada. A Roth conversion may be an underutilized tool for people returning to Canada **or US residents with Canadian beneficiaries.**

This is a simplified example of a complex strategy that needs careful consideration on both sides of the border before implementation. There are numerous things that must be done and documented to keep the tax-free nature of the Roth in place here in Canada. You should speak with a cross-border specialist before attempting to do any of the described strategies. Feel free to reach out to me with any questions or comments: chris.stooksbury@raymondjames.ca or toll free @ 1.844.558.8752

Cheers,

Chris

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