

# STEP JOURNAL

## Retirement, recalculated

Kevyn Nightingale TEP and Shlomi Levy TEP discuss the 'zero-investment' provision and the deferred taxation on income accrued in Canadian retirement savings plans when the plan holder becomes a resident of the United States

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Taxation	Status
RRSPS	DELAYED
RRIFs	DELAYED
IRS	OVERREACHING

## What is the issue?

Reporting distributions from Canadian registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs) in the United States is more complicated than one may think; there are hidden risks.

## What does it mean for me?

Members, especially those who advising on cross-border tax or preparing US returns for individuals with RRSPs and RRIFs, need to be aware of these risks.

## What can I take away?

It may be worth reconsidering use of the treaty's deferral of RRSP income.

## Canadian taxation

A Canadian registered retirement savings plan (RRSP) is a tax-preferred retirement vehicle. Conceptually, for Canadian purposes:

- contributions are deductible;[\[1\]](#)
- there are limits to contribution;[\[2\]](#)
- earnings within a plan are tax-deferred;[\[3\]](#) and
- withdrawals are fully taxable.[\[4\]](#)

A registered retirement income fund (RRIF) is a continuation of an RRSP with mandatory minimum withdrawals.<sup>[5]</sup> Where the annuitant is a non-resident of Canada at the time of withdrawal, tax is withheld at a flat rate of 25 per cent.<sup>[6]</sup> There is a reduced (15 per cent) rate for RRIF withdrawals by US residents<sup>[7]</sup> under limited circumstances.<sup>[8]</sup> For the remainder of the article, 'RRSP' includes an RRIF.

## United States taxation

Sometimes, the owner of an RRSP is a US citizen or tax resident. Most often, this occurs where a former Canadian has migrated to the United States.

### *Domestic law*

US tax law does not provide special treatment for an RRSP. Income earned inside a plan is taxable no differently than any other type of investment income. Income is reportable as it is earned, and withdrawals are irrelevant. A foreign tax credit is allowed for Canadian tax.<sup>[9]</sup>

### *The Treaty*

The *Canada-US Income Tax Convention* (the Treaty) allows the annuitant to defer recognition of income earned within the plan until withdrawal.<sup>[10]</sup>

***'A natural person ... may elect to defer taxation in the [United States] ... with respect to any income accrued in the plan but not distributed by the plan...'*<sup>[11]</sup>**

This election is taken by the vast majority of taxpayers, as it allows matching of the timing of income recognition. This way, the US foreign tax credit generally aligns with the Canadian tax paid. In the ordinary course, an RRSP subject to this election is conceptually treated as a pension plan.<sup>[12]</sup>

### *Components of a plan*

Each withdrawal is divided into two parts: investment in the contract (investment),<sup>[13]</sup> which is tax-free, and accumulated income (income), which is taxable at ordinary graduated rates. This article assumes that contributions are only made by individuals resident in Canada. There are only two possibilities for the US tax status of such an individual at the time contributions are made: they could have been a US person or a non-resident alien.

For a US person, the United States does not generally allow a deduction for contributions, as an RRSP is not a 'qualified plan'. Consequently, contributions are considered investment in this circumstance.

For a former non-resident alien, investment has historically been equal to the cost of the securities at the time of assumption of US residency. Effectively, this includes pre-departure realised gains. This figure probably differs from the plan's value at that time, because there are likely unrealised net gains or losses.

***The purpose of the Treaty provision is to defer taxation; it is a timing provision.***

### ***Allocation to each component upon withdrawal***

Each withdrawal attracts a pro rata share of investment. For instance, if the value in a plan is USD1,000 and the investment is USD300, a withdrawal of USD100 would consist of a basis of USD30 and USD70 would be taxable. Careful records must be maintained over time.

The income portion is taxable at ordinary graduated rates.[\[14\]](#) A foreign tax credit is allowed. In the authors' experience, this is the manner in which most competent tax professionals are preparing returns. In 1989, this approach was explicitly sanctioned by the Internal Revenue Service (IRS),[\[15\]](#) but that Revenue Procedure has since been superseded.

### ***Taxation of investment***

For someone who was a non-resident alien at the time contributions were made, there has been concern that the full amount of each withdrawal is taxable (i.e., the investment would be zero). This concern stems from a 2004 change to the law.[\[16\]](#) This position is reinforced by a 2014 Revenue Procedure stating that 'the entire amount of each distribution will be subject to US Federal income tax'.[\[17\]](#) The authors suggest that this provision is not applicable, and there continues to be investment for such a person.

### ***Nature of the plan***

The 'zero-investment' provision applies to an 'employer or employee contribution', implying that the contributions needed to be made in respect of an employment relationship.[\[18\]](#) In general (group plans aside), an RRSP contribution is not directly connected to an employment relationship. Contributions are not made by, or because of, an employer. Because of the cumulative nature of contribution room, contributions may be made in years where there is no employment income; the deduction can offset any type of income.

While RRSP deduction room is often generated by employment income, other types of income that create room include:

- business income;[\[19\]](#)
- rents;
- royalties where the individual was the investor or author;[\[20\]](#)
- child or spousal support;[\[21\]](#)
- scholarships and bursaries;[\[22\]](#) and
- Canada Pension Plan or Quebec Pension Plan disability benefits.[\[23\]](#)

### ***Grantor trust***

In 2002, an RRSP was viewed by the IRS as a grantor trust (with the assets owned by the annuitant). [\[24\]](#) Contributions and income earned prior to migration were not taxable for US purposes. That Revenue Procedure has been superseded.[\[25\]](#)

Typically, an RRSP is set up in the form of a trust under Canadian law but may not qualify as a trust under US tax law. If it were a trust, it would certainly be a grantor trust.[\[26\]](#)

### ***Intent of the Treaty***

The purpose of the Treaty provision is to defer taxation; it is a timing provision. There is no element indicating that the quantum of income recognised should change.

Under US domestic law, only income earned and gains realised after US immigration would be taxable. Contributions and pre-immigration income are excluded. This treatment is currently acknowledged by the IRS.[\[27\]](#) It would be odd if use of the Treaty caused otherwise non-taxable income to become taxable.

***The zero-investment rule may not be self-executing without regulations being issued; none have been issued.***

### ***Form 8891***

Form 8891, applicable for the years 2004–2014, recognised a difference between taxable and total distributions.[\[28\]](#) This supports the contention that the IRS agreed, after 2004, that some portion of withdrawals is exempt from tax.

### ***Scope limitations***

The zero-investment rule excludes an ‘applicable nontaxable contribution’. This is one ‘which was not subject to income tax ... under the laws of ... any foreign country’. RRSP contribution room is largely created by remuneration for employment or self-employment. In each of these cases, Canada (or Quebec) Pension Plan contributions are required. These payments are viewed as income taxes by the United States.[\[29\]](#) Therefore, in most cases, Canadian income tax did apply to the contribution.

The zero-investment rule may not be self-executing without regulations being issued;[\[30\]](#) none have been issued. The Internal Revenue Manual has no direction for agents on this question, only for foreign bank account reporting.[\[31\]](#)

The IRS may yet have scope for action, as the Treaty allows deferral ‘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’.[\[32\]](#)

## Summary

In the authors’ view, the IRS is likely overreaching with the wording of the Revenue Procedure, and the 2004 inclusion rule is not relevant. The authors are not aware of the IRS auditing for this issue or reassessing taxpayers in respect of their RRSP inclusions.

As an aside, the US foreign tax credit may solve the problem from a practical standpoint in many cases, rendering the question largely moot.[\[33\]](#)

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- [\[1\]](#)Income Tax Act (Canada) (ITA), s.60(i)
  - [\[2\]](#)ITA, s.146(1) ‘RRSP deduction limit’
  - [\[3\]](#)ITA, s.146(4)
  - [\[4\]](#)ITA, s.56(h)
  - [\[5\]](#)ITA, s.146.3(1) ‘minimum amount’
  - [\[6\]](#)ITA, s.212(1)(l), (q)
  - [\[7\]](#)Canada-US Income Tax Convention (the Treaty), art.XVIII(2)(a)
  - [\[8\]](#)Income Tax Conventions Interpretation Act, s.5 ‘periodic pension payment’
  - [\[9\]](#)Internal Revenue Code (IRC), s.901(a)
  - [\[10\]](#)The Treaty, art.XVIII(7); US Treasury Department Technical Explanation of the Convention, art.9; Rev. Rul.89-95
  - [\[11\]](#)The Treaty, art.XVIII(7)d
  - [\[12\]](#)The Treaty, s.6
  - [\[13\]](#)IRC, s.72(c)(1)
  - [\[14\]](#)IRC, s.72(a)
  - [\[15\]](#)Rev. Proc. 89-45, s.4.03
  - [\[16\]](#)IRC, s.72(w)
  - [\[17\]](#)IRS, IR-2014-97, Rev. Proc. 2014-55, s.7

- [\[18\]](#)IRC, s.72(2)(2)(A)(i)
- [\[19\]](#)ITA, s.146(1) 'earned income' (a)(ii)
- [\[20\]](#)ITA (iii)
- [\[21\]](#)ITA (b)
- [\[22\]](#)ITA (b.01)
- [\[23\]](#)ITA (b.1)
- [\[24\]](#)Rev. Proc. 2002-23
- [\[25\]](#)Rev. Proc. 2014-55, s.1
- [\[26\]](#)

IRC, ss.671, 672(f)(2)(A), 673(a), 675 and 676

- [\[27\]](#)Rev. Proc. 2014-55, s.2.01
- [\[28\]](#)

#### [Form 8891](#)

- [\[29\]](#)Rev. Rul. 68-411
- [\[30\]](#)IRC, s.72(w)(4)
- [\[31\]](#)IRM, s.4.26.16.3.3
- [\[32\]](#)The Treaty, art.XVIII(7)
- [\[33\]](#)

*The authors acknowledge the valuable assistance of Max Reed of Polaris Tax, but the contents of this article are solely the authors' responsibility.*

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