TO: Canada Revenue Agency
FROM: Steve Kobes
DATE: Dec 29, 2020
SUBJECT: **Comment re. Folio S5-F3-C1, Taxation of a Roth IRA**

Dear Sir or Madam:

This comment provides feedback on the content of Income Tax Folio S5-F3-C1, Taxation of a Roth IRA (the Folio), which was published Oct 9, 2020 and is currently within the three-month comment period.

The Folio is a welcome revision of the guidance previously found in Income Tax Technical News No. 43 relating to Roth IRAs and the election to defer taxation under the US-Canada tax treaty. However, I believe there is an opportunity for the Folio to provide greater clarity about the treatment of Roth 401(k) arrangements under the Income Tax Act.

I propose a revision to the Folio, with new text provided in Part V below. This revision would eliminate ambiguity about the meanings of "arrangement" and "employer contribution" in the case of a 401(k) plan with separate accounts for different contribution types.

I am not a lawyer, and no part of this comment is intended as legal advice.

I. Background — Roth 401(k)

A 401(k) plan is an employees' trust which meets certain qualifications under section 401 of the US Internal Revenue Code (IRC), including a "cash or deferred arrangement" in which the employee directs the employer to make contributions on his or her behalf ("elective deferrals"). Traditionally, this deferral of income comes with a corresponding deferral of US tax.

The term "Roth 401(k)" refers to an account within a 401(k) plan which tracks certain elective deferrals which are "designated Roth contributions" as defined in IRC § 402A(c)(1). This account is treated similarly to a Roth IRA for US tax purposes: no tax benefit in the year of contribution, but tax-free investment growth and distribution from the plan.

The plan may also provide for the employer to make a "matching contribution"—i.e., an additional amount contributed by the employer on account of ("matching") an elective deferral.

1. An elective deferral is an employer contribution, but only formally.

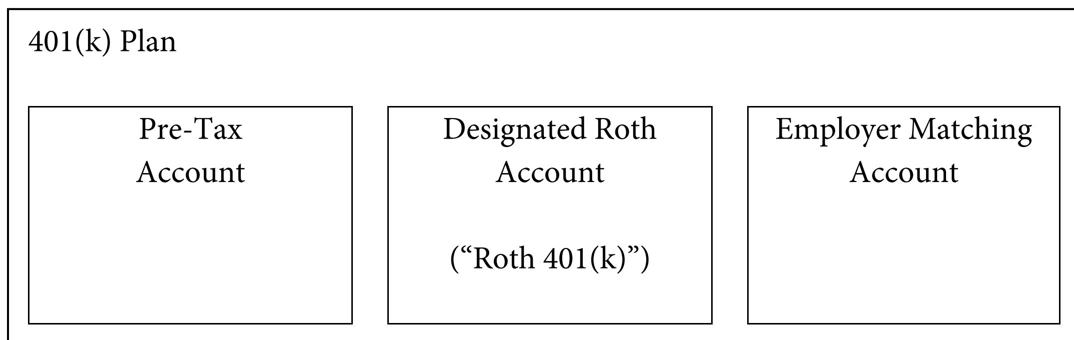
US law calls the elective deferral an "employer contribution" to the plan[1], but this describes the mechanism and not the substance of the transaction. The contribution is made "on behalf of the employee"[2], who forgoes current wages by electing the deferral. Thus the employer merely acts as an agent for a contribution by the employee.

In less technical contexts, an elective deferral is commonly described as an "employee contribution".[3]

2. The plan may contain a mix of Roth and non-Roth accounts.

Typically, a 401(k) plan does not hold Roth contributions exclusively, but instead tracks in separate accounts an employee's ordinary elective deferrals ("pre-tax account"), elective deferrals which are designated Roth contributions ("designated Roth account"), and employer matching contributions ("employer matching account"). Only the designated Roth account receives US tax treatment resembling the Roth IRA.

The figure below illustrates an arrangement of separate pre-tax, Roth, and employer matching accounts within a 401(k) plan.



[1] See e.g. IRC § 401(k)(2)(A) ("a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee, or to the employee directly in cash"); § 402(g)(3)(A) ("elective deferral" includes "employer contribution under a qualified cash or deferred arrangement"); Treasury Regulation § 1.401(k)-1(a)(4)(ii) ("Treatment of elective contributions as employer contributions").
[2] IRC § 401(k)(2)(A).
[3] E.g. https://www.investopedia.com/terms/1/401kplan.asp: "In a traditional 401(k), *employee contributions* reduce their income taxes for the year they are made, but their withdrawals are taxed." (emphasis added)

II. Treaty benefits for Roth 401(k)

The US-Canada tax treaty provides benefits to Canadian residents with US pensions, including an election to defer Canadian tax on income accrued but not distributed by a plan to provide "pension or employee benefits"[4], and an exclusion from Canadian tax for "pension" distributions which would be non-taxable in the hands of a US resident[5].

The treaty defines "pensions" to include a Roth IRA, but envisions that it may also embrace "a plan or arrangement … that the competent authorities have agreed is similar thereto"[6].

The Treasury Department's Technical Explanation of the Fifth Protocol, to which Canada has given its assent, explains that "the term 'pensions' includes pensions paid by private employers (including pre-tax and Roth 401(k) arrangements)"[7].

With the Technical Explanation, we are left no room for doubt as to the *availability* of the XVIII(7) treaty election for a designated Roth account in a 401(k) plan, should it be needed. If the account does not enjoy Canadian tax deferral by the terms of the Income Tax Act, then such deferral may be achieved by the treaty election. However, if the Income Tax Act confers equivalent tax deferral on the Roth 401(k), then the treaty election is unnecessary.

III. Ambiguity of the Folio's current guidance

Taxpayers who come to Canada with a 401(k) plan that includes a designated Roth account will look to the Folio for guidance on whether to file the treaty election. Unfortunately, the current language may not give them the certainty they desire.

Paragraph 1.26 provides a general discussion of "other types of U.S. retirement arrangements" such as "401(k) … plans (including Roth accounts)". It continues as follows:

> "Whether an individual should file the Election for such an arrangement depends on whether the income accrued in the arrangement is taxable under the Act on a current basis. This would require a complete review of the facts and terms of the particular arrangement. However, it is the CRA's understanding that employers typically make

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[4] United States–Canada Income Tax Convention (1980), as amended by the Protocols signed in 1983, 1984, 1995, 1997, and 2007 ("US-Canada tax treaty"), Art. XVIII(7).
[5] US-Canada tax treaty, Art. XVIII(1).
[6] US-Canada tax treaty, Art. XVIII(3)(b), subject to the exclusion for Canadian Contributions discussed in paragraphs 1.12–1.14 of the Folio.
[7] US Treasury Department, Technical Explanation of the 2007 Protocol, Article 13 (amending treaty Article XVIII).

contributions to such arrangements, in which case the arrangement will be characterized either as an employee benefit plan (EBP) or a retirement compensation arrangement (RCA), as those terms are defined in subsection 248(1). Because an individual who holds an interest in an EBP or RCA is not subject to current taxation under the Act on the income accrued in the arrangement, there is no benefit in filing the Election."

Paragraph 1.27 goes on to warn: "Where no employer contributions are made, the arrangement will not be characterized as an EBP or a RCA". In that case, an election would be needed.

It seems from paragraph 1.26 that the CRA generally believes typical 401(k) plans with designated Roth accounts would not require the election. But the cautionary emphasis on employer contributions may undermine the taxpayer's confidence in that conclusion.

In considering whether "employer contributions" are made to a "retirement arrangement" for purposes of the Folio's guidance, with reference to the type of plan described in Part I of this comment, two ambiguities present themselves:

- Is the entire 401(k) plan a single "arrangement", or is each separate account (pre-tax, designated Roth, and employer matching) a separate "arrangement"?

- Does an "employer contribution" include an elective deferral, or does "employer contribution" refer exclusively to a matching contribution?

If the entire 401(k) plan is a single "arrangement", then per the Folio's guidance it does not require a treaty election, because the employer contributes to the plan.

If each account is a separate "arrangement", and "employer contribution" includes an elective deferral, then per the Folio's guidance the designated Roth account in the 401(k) plan does not require a treaty election, because the elective deferrals which are designated Roth contributions constitute employer contributions.

But if each account is a separate "arrangement", and "employer contribution" refers only to a matching contribution and not an elective deferral, then a treaty election is required for the designated Roth account. This is because the matching contributions flow into a separate account, and not into the designated Roth account.

IV. Proper treatment of Roth 401(k) under the Income Tax Act

In my own view of the proper interpretation of the Income Tax Act, informed by case law and CRA guidance, the 401(k) plan described in Part I of this comment should generally be treated in its entirety as an "employee benefit plan" (EBP). Under this position, no treaty election is required, either for the plan as a whole or for the designated Roth account within the plan.

1. A 401(k) plan is generally an employee benefit plan.

It is the CRA's longstanding position that a 401(k) plan is generally an EBP. See for example Technical Interpretation 9410515.

The Folio also considers that a 401(k) plan may be a "retirement compensation arrangement" (RCA). But in the common case of a taxpayer who moves to Canada from the US, and holds (but stops contributing to) a plan with their former US employer, such a plan is likely "maintained primarily for the benefit of non-residents in respect of services rendered outside Canada" and thus fails to be an RCA[8].

Without RCA status, the plan is likely an EBP, which is the "residual characterization for income-deferral arrangements not otherwise covered by the Act".[9]

However, the definition of "employee benefit plan" in s. 248(1) requires that under the arrangement, "contributions are made by an employer" (or by a person not at arm's length to the employer). A 401(k) plan which fails to satisfy this condition is not an EBP.

2. An elective deferral is not properly regarded as an employer contribution for purposes of EBP status.

An elective deferral is in effect a contribution by the employee (see Part I.1, above). Therefore, for the purpose of the definition of "employee benefit plan" in the Income Tax Act, an elective deferral should not be construed as a contribution "made by an employer".

This interpretation is consistent with a "substance over form" approach to characterizing contributions. It also accords with case law in *Jacques v. The Queen*[10], which considered the absence of "employer contributions" to weigh against the status of a 401(k) distribution as a

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[8] Income Tax Act, s. 248(1), definition "retirement compensation arrangement", clause (l).
[9] Kahane, Karadzic, and Létourneau-Laroche, "A Fresh Look at Retirement Compensation Arrangements" (2013) 61:2 *Canadian Tax Journal* 479-502, at 482.
[10] 2016 TCC 245.

"superannuation or pension benefit". There the Tax Court considered elective deferrals to be employee contributions, and not employer contributions, for the purpose of its analysis.

The CRA would be correct to deny EBP status to a plan under which the employer makes no contribution other than an elective deferral.

3. A plan with multiple accounts is properly regarded as a single arrangement.

It would be an unnatural result for a 401(k) plan, or any part of the plan, to be denied the status of an EBP merely because it tracks multiple types of contributions separately.

For example, if a plan tracks elective deferrals separately from the employer matching contributions that are made on account of those deferrals, it is not sensible for the elective deferral account to lose the status of an EBP on the grounds that the employer does not contribute to that account.

Similarly, no part of the plan should be denied the status of an EBP merely because the plan incorporates a designated Roth account.

The structure and organization of a 401(k) plan suggests that it should be considered a single arrangement, even when it contains multiple accounts. The plan is typically governed by a single document, and its provisions apply a tight coordination between the accounts.

4. CRA regards treaty elections for Roth 401(k) as generally unnecessary.

When taxpayers do file a treaty election for a 401(k) plan with a designated Roth account, the CRA's current practice appears to be to notify them by private correspondence that the election is not required.

See attached Exhibit A, in which the Competent Authority Services Division represented to the taxpayer: "With respect to your Roth 401(k), Canadian tax rules already provide a deferral of tax and, therefore, an election is not required for this account."

The CRA seems to have drawn this conclusion categorically on the basis of the account's status as a Roth 401(k), with no consideration given to the specific terms of the Plan Document (with which they were not provided).

The conclusion that best accords with Canadian law and existing CRA policy is that a 401(k) plan with a designated Roth account does not require any treaty election when its owner becomes a Canadian resident.

V. *Clarifying the Folio*

I propose that the following paragraphs be inserted following paragraph 1.27 in the Folio:

> For the purpose of ¶1.26–1.27, an employer contribution includes an employer's "matching contribution" made on account of an employee's contribution, but does not include an amount contributed by the employer on behalf of the employee under an election of the employee, which would otherwise be payable to the employee as compensation in the year of the contribution.
>
> Where an arrangement such as a 401(k) plan contains separate accounts for different types of contributions for the same beneficiary, such as Roth and non-Roth accounts, the arrangement will not fail to be characterized as an EBP or an RCA solely because the employer contributions are not made into a Roth account. If such an arrangement is an EBP or an RCA, then the Election is not required.

The first inserted paragraph would remove ambiguity with respect to elective deferrals in a 401(k) plan (see Part I.1 and Part IV.2, above).

The second inserted paragraph would remove ambiguity with respect to designated Roth accounts in a 401(k) plan, where employer matching contributions are made into a different account (see Part I.2 and Part IV.3, above).

With these insertions, the CRA would clearly and publicly communicate the correct position which it already appears to take in individual cases (see Part IV.4, above): that such plans do not typically require any treaty election.

In the interests of taxpayer certainty and reducing the administrative burden of responding to unnecessary treaty election submissions, I urge the CRA to consider adopting the revision.

Thank you for your consideration.

Steve Kobes
e-mail: steve@kobes.ca

EXHIBIT A

Canada Revenue Agency / Agence du revenu du Canada

JUN 2 4 2020

Steven L. Kobes

LBD-

Tel:
Fax:

Dear Mr. Kobes:

Subject: Elections for United States Pension Plans

We are writing in response to your election dated April 19, 2019 concerning your Roth 401(k) account with Google LLC and your Roth Individual Retirement Arrangement (IRA) account with Vanguard. You indicated that you wished to elect to defer Canadian tax on income earned in these plans. We apologize for our delayed response.

An individual may make an election to defer Canadian tax where the income earned in certain United States (U.S.) pension plans would otherwise be taxable under the *Income Tax Act* on an annual basis. With respect to your Roth 401(k), Canadian tax rules already provide a deferral of tax and, therefore, an election is not required for this account. On the other hand, the income earned in a Roth IRA is generally taxed on an annual basis. As a result, the election for your Roth IRA will allow you to defer tax on income earned in your Roth IRA account.

Please note that if you (or someone on your behalf) make(s) a contribution to this account after April 9, 2018 while you are a resident of Canada, any income earned and distributions after the contribution date will generally become taxable in Canada, except if the contribution was transferred from another Roth IRA or a Roth 401(k) that qualifies as a pension under Article XVIII of the *Canada-U.S. Tax Convention*.

You should keep a copy of the records related to the Roth IRA in case we ask to see them at a later date.

Yours sincerely,

, Director
Competent Authority Services Division
International and Large Business Directorate
Canada Revenue Agency