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BE CAREFUL WITH RESPS FOR U.S. PERSONS

Frank Di Pietro / September 13, 2016

U.S. persons living in Canada face multiple tax-filing obligations with respect to their worldwide assets. And while we've heard a lot about how RRSPs, RRIFs and TFSAs are affected by U.S. rules, one plan that has received much less attention is the RESP. Specifically, what are the U.S. income tax implications and filing obligations if a Canadian-resident parent or grandparent is considered a U.S. person and decides to set money aside in an RESP?

RESP REFRESH

RESPs are popular vehicles to help save for education. One of the biggest benefits to RESPs is that the government provides matching grants, known as the Canada Education Savings Grants (CESGs) of up to $500 per year (20% of the $2,500 annual max contribution). Contributions are typically made by a parent or grandparent who becomes the subscriber to the RESP. They do not receive any income-tax deductions with respect to contributions, but income and gains earned on the contributions, as well as the grants, accumulate on a tax-deferred basis. Assuming the RESP's beneficiaries attend post-secondary school, they are entitled to receive payments from the RESP (known as Educational Assistance Payments) to help fund these costs. EAPs are taxable to the beneficiary child(ren), who are very likely to be taxed at lower tax rates relative to their parents or grandparents. Knowing that, RESPs are a powerful income-splitting tool for parents and grandparents.

DOUBLE TAX ISSUES

For a U.S. person, there can be punitive consequences to being an RESP subscriber. Unlike qualifying RRSPs and RRIFs, which obtain continued tax deferral for all income and gains earned inside the plan due to provisions under the Canada-U.S. tax treaty, RESPs have no such relief . This means that for U.S. income tax purposes, an RESP is not a tax-deferred plan. As a result, any income and capital gains earned within the RESP are subject to U.S. tax on an annual basis.

Additionally, any CESGs paid by the government into the RESP are also taxable to the U.S. parent or grandparent who remains a subscriber to the plan. Without proper tax planning, this could create a double tax issue for the family. That would happen because the U.S. person, as a subscriber, is subject to U.S. tax on grants, income and gains earned in the RESP, while the Canadian beneficiary child or grandchild is subject to Canadian income tax on the same sources of income (grants, income and gains) paid in the future as EAPs.

U.S. DISCLOSURE REQUIREMENTS

In addition to the income tax issues, there are also filing disclosures that must be met in the U.S. This is where a grey area exists. The general view among tax practitioners and cross-border experts has been that RESPs are considered foreign trusts for U.S. federal income tax purposes. If this is true, the U.S. subscriber would be required to provide information and transactional details relating to the RESP via IRS forms 3520 and 3520-A. These forms are in addition to the U.S. income tax returns. The penalty for not filing Form 3520 is the greatest of $10,000, 35% of the gross distributions received, 35% of annual contributions to the plan, or 5% of the gross value of plan the client owns. There are also penalties for late filing.

Recently, however, there has been debate as to whether RESPs are in fact foreign trusts . With the language used in Canada with respect to RESPs, such as “beneficiary” and “trustee”, it’s not surprising that most people believe an RESP is a trust. Under the Income Tax Act, an RESP is called an “arrangement” between an individual (the subscriber) and a person or organization who offers the RESP (known as a promoter) for the purpose of funding education costs for a related person (the beneficiary). As a result, an RESP is a contractual arrangement between the subscriber and the promoter, and exhibits non-trust-like characteristics.

On the other hand, a trust under Canadian law is generally structured as follows: An individual (settlor) contributes and gives up property to a trustee for the benefit of a third party (beneficiary). The settlor is not the legal owner of the assets; rather, the trustee holds legal title and is bound by fiduciary obligations to administer the trust on behalf of the beneficiary.

Knowing all that, here are arguments for why an RESP may not be a trust.

- An RESP is considered an asset of the subscriber. The subscriber is entitled to keep RESP assets until the beneficiary receives payments for the purpose of funding post-secondary education. A trust settlor, however, usually gives up property.
- The subscriber is in full control and may choose to have his or her contributions refunded at any point in time during the life of the RESP. A settlor cannot place assets in a trust while still retaining disposition rights.
- The Income Tax Act does not name the promoter as the owner of the RESP, which would likely be the case if an RESP was a trust for tax purposes.
- A trust is a separate taxpayer. If an RESP is a trust, then it would be required to file annual tax returns. Agency agreements are exempt from this filing requirement. RESPs are not required to file tax returns.
- Canadian courts have indicated that RESPs are not trusts under Canadian law.
- The IRS has stated that RRSPs are considered trusts for U.S. federal income tax purposes. There has not been any indication from the IRS that RESPs are trusts.

If the U.S. deems RESPs to be foreign trusts, then the rules discussed above pertaining to the disclosure filing (i.e., Forms 3520/3520-A) will apply to U.S. persons as subscribers to RESPs. However, some tax practitioners have taken the position that RESPs are not trusts for U.S. federal income tax purposes for the reasons described above, among others. Therefore, if an RESP is not a trust for U.S. federal income tax purposes, clients are not required to file Forms 3520/3520-A.

Unfortunately, this is an area where the IRS has provided little guidance. In our view, the simplest approach would be to avoid naming a U.S. person as subscriber to the plan and instead have another family member (e.g., spouse, partner or parent) consider subscribing to an RESP. This alleviates any concern over the tax issues described above or uncertainty over how to meet the IRS disclosure requirements. However, any U.S. client who remains a subscriber should obtain qualified advice from a professional, who will take a position and support that position on your client’s behalf.