CARDINAL | POINT

CROSS-BORDER WEALTH MANAGEMENT

The Health Savings Account in a Canada-U.S. Context

www.cardinalpointwealth.com

You work hard to earn your money. You live below your means and have extra funds to save for retirement or a rainy day. But with all the different types of savings and investment accounts available, which should you prioritize? Once you've stashed away three to six months of living expenses in a basic savings account to cover unexpected emergencies like insurance deductibles, out-of-pocket medical expenses, and auto repairs, it's time to turn your attention to other savings or investment accounts that provide a tax benefit, allowing more of your money to be invested and ultimately returned back to you. Below are the factors to consider:

- Are contributions to the account deductible?
- Does the account provide tax deferral of investment income?
- How are distributions taxed?

The best scenario for an investment account is one that allows deductible contributions, tax-free investment income, and tax-free distributions. This means you never pay tax on the contribution, the income, or the distributions. The following chart summarizes the tax treatment of the most popular types of accounts in the U.S. and Canada. With the exception of differing contribution and income limits, IRAs, 401(k)s, 403(b), SIMPLE IRAs, SEP IRAs, and individual defined benefit plans are all very similar, and those accounts are usually rolled into an IRA upon retirement.

Tax Treatments of Popular Types of Accounts in the U.S. and Canada

	Taxable Investment	401(k)	IRA	ROTH IRA	HSA	529	RRSP	TFSA	RESP
Deductible		Yes	Yes		Yes		Yes		
Income Deferral		Yes	Yes				Yes		Yes
Tax-free Investment Income				Yes	Yes	Yes		Yes	
Tax-free Distribution	Capital gains are taxed			Yes	Yes	Yes		Yes	Taxed to student
Annual Contribution Limit	Unlimited	$20,500	$6,500	$6,500	$3,650 ($7,300 for family coverage)		$29,210	$6,000	20% CESG up to $2,500
Catch-up Contribution		$6,500 for 50+	$1,000 for 50+	$1,000 for 50+			cumulative limit	cumulative limit	cumulative limit
Lifetime Contribution Limit						$235,000+ determined by state		$81,500	$50,000
Age Restriction		59.5	59.5		65				31 years after inception
Early Withdrawal Penalty		10%	10%		20%	10%			20%
Penalty Portion		Full	Full		Full	Earnings			Earnings
RMD		Yes	Yes				Yes		36-year limit

The HSA is the only type of account that has the benefit of a deduction for the contributions, tax-free investment income, and tax-free distributions. HSAs combine the tax attributes of an IRA and a Roth IRA in that you get a deduction on the way in, and it is tax-free on the way out, but only if distributions are used to pay eligible healthcare expenses. HSAs are also similar to Roth IRAs in that there is no required minimum distribution.

Distributions from taxable investment accounts are not fully taxable like distributions from an IRA, but capital gains are taxed. HSAs (healthcare) and 529s (education) must be spent on qualified expenses or else they are taxable with a penalty rather than tax-free. The exception to this rule is that HSA funds can be withdrawn for any reason with no penalty after the age of 65. In this case, the distribution is taxable like an IRA, but no penalty applies.

Another benefit of HSAs is they are the only account that provides for an “above-the-line” deduction, which means they are deducted before totaling Adjusted Gross Income (AGI) so there are no income limits on HSA deductibility. IRA contributions are also above the line but are potentially subject to income limits. Many employed taxpayers are eligible for executive compensation packages through their employer, have a spouse who has an employer-sponsored retirement plan, or their high income disqualifies them from contributing to a traditional IRA. There is no income limit for IRA and Roth IRA contributions if neither spouse has access to a qualified employer sponsored retirement plan.

The only qualification for receiving a deduction for a contribution to an HSA is the participant must be enrolled in a qualified High Deductible Health Plan (HDHP). Retired clients generally are on Medicare, do not need the tax deduction, or have retirement health benefits provided by their former employer which are not considered a HDHP.

For the most part, the HDHP requirement means that those living in Canada are not eligible to make U.S. tax deductible HSA contributions. Canadians are covered by provincial healthcare, which is not considered a HDHP. Besides, there is no deduction in Canada for HSA contributions. There would be no advantage to contribute because people generally pay more tax in Canada and need Canadian deductions. Even as a dual resident, the deduction in the U.S. will not benefit you because the foreign tax credits created in Canada will usually offset your U.S. tax payable.

HSAs were not included in the Canada-U.S. Tax Treaty, so investment income is taxable in Canada even though it is not taxable in the U.S. Our advice to those moving to Canada with existing HSA accounts is to keep the account open because you would not want to take a taxable distribution with the penalty before you leave. However, you should make sure to use the HSA account for all your healthcare needs in the U.S. and Canada. Expenses incurred for healthcare in Canada are considered qualified healthcare expenses and will not trigger a penalty.

The reason you want to make sure to spend your HSA down as quickly as possible once entering Canada is because:

- Having an account that is tax-free from a U.S. perspective, but viewed as a taxable investment account in Canada, will create accounting complexities for tax reporting purposes. HSAs do not issue tax slips to detail investment income. You will have to review the account transaction history to determine the taxable investment income from a Canadian perspective. You will then have to convert the income to Canadian dollars on the date of the transaction, then sum all the Canadian income by type to report on your Canadian return. As you can see, this could get complex.

- HSA providers have become more uncommon in the U.S. over the past 10 years. Many large banks used to offer HSA accounts, but many providers have exited the market.

- Investment options may be limited and may require a minimum account balance.

    - Many HSA providers do not offer the option of investing in equities. Often the only option is a high-yield savings account. If your provider does offer equity investments, the account may be frozen once you change your address to a foreign address. Once that happens, you will only be able to sell securities, not purchase new ones. This may not be an issue if your investments are appropriate before you move. The equities in your account may also be frozen once your account balance drops below the minimum.

- If you are not able to invest in equities, the small amount of interest income you are receiving is only complicating your life.

- Once you move to Canada, your HSA essentially becomes a taxable account with the downside of potential penalties and tax reporting complications. You are no longer receiving tax-deferred or tax-free investment income, so you should use the HSA for Canadian medical expenses rather than your taxable investment account.

- Many providers will not mail a new debit card to a foreign address if you lose your debit card. You may also have checks to use, or you could transfer balances from your HSA to your checking account online or via the phone. Make sure to save your health expense receipts if you do this.

While HSA accounts are not appropriate for everyone, they are the most tax-friendly accounts in the U.S. They may be included in the sixth protocol to the Canada-U.S. tax treaty when it is updated in the future.

There are similar issues with Tax-Free Savings Accounts (TFSA) and Registered Education Savings Plan accounts (RESP) for Canadians living in the U.S. in that they are not recognized by the treaty, create taxable investment income in the U.S., and complicate your tax filings. The problem is worse with TFSAs and RESPs than with HSAs because they can be considered foreign trusts.

If you have moved across the Canada-U.S. border or are living a cross-border lifestyle, it is important you work with a qualified cross-border specialist to optimize your financial situation and avoid the landmines inherent in cross-border financial planning, tax planning, and investment management.

Contact Cardinal Point for more information

CARDINAL | POINT

CROSS-BORDER WEALTH MANAGEMENT

Copyright © 2022. Cardinal Point Wealth Management Partners, LLC and Cardinal Point Capital Management ULC All Rights Reserved.

"Cardinal Point" is the brand under which the dedicated professionals within the independent Cardinal Point Group of Companies collaborate to provide financial and investment advisory, risk management, financial planning and tax services to selected clients. Cardinal Point comprises two legally separate companies: Cardinal Point Wealth Management Partners, LLC, a U.S. registered investment advisor and Cardinal Point Capital Management ULC is a U.S. registered investment advisor and a registered portfolio manager in Canada (ON, QC, MB, SK, NS, NB, AB, BC). Advisory services are only offered to clients or prospective clients where the independent Cardinal Point firms and its representatives are properly registered or exempt from registration. Each firm enters into client engagements independently. This website is solely for informational purposes. Past performance is no guarantee of future returns. Investing involves risk and possible loss of principal capital.