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Withholding Taxes – Part 2

The Impact on Non-Residents Investing through an Account in Canada

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In accordance with requirements under foreign securities legislation for certain countries, this article can only be provided to non-resident clients upon their request.

This article addresses the Canadian non-resident withholding tax rules where a non-resident of Canada purchases Canadian and/or U.S. investments through a taxable account located in Canada. The article also addresses the Canadian non-resident withholding tax rules where a non-resident of Canada makes a withdrawal from a Canadian registered plan such as an RSP or RIF. Generally, withholding tax on investment income is an important factor for non-resident investors since it impacts the after-tax yield – how many dollars that are left over after taxes that can be spent or reinvested.

Note that there are certain compliance restrictions for non-residents (especially U.S. residents) investing through an account held with an account located in Canada. More information on this issue is available from your advisor.

Canadian Investments Owned by Non-residents through an Account in Canada

In order to determine the amount of withholding tax that a non-resident of Canada would pay on investment income from Canadian-based investments, one must generally consider the following four issues:

i) The investor’s foreign country of residence;
ii) Canadian domestic tax laws;
iii) The tax treaty between Canada and the investor’s foreign country of residence (if a treaty exists); and
iv) The type of investment income earned.

RESIDENCY

Residency is generally determined where the individual spends the majority of his/her time, where the individual is employed, or where the individual’s immediate family lives. In most cases, a person's status as a resident or non-resident of a country can easily be determined. However, if the residency status of the individual is uncertain, then a tax advisor or the tax department of the foreign country’s government should be consulted. It is important to recognize that residency, not citizenship, is relevant when determining the applicable Canadian withholding tax rate.

AVOIDING DOUBLE TAXATION

Many countries (including Canada) have an advanced income tax system that requires its residents to report and pay tax on their worldwide income. Therefore, to avoid double taxation of Canadian source income (i.e., Canadian non-resident withholding tax and foreign country tax on the same income), taxpayers are generally allowed to claim a foreign tax credit on their foreign country income tax return for Canadian non-resident taxes. By allowing a credit for the Canadian non-resident taxes, the investor's foreign home country taxes are reduced.

Investment income (except exempt interest income and capital gains - see below) earned in Canada by a non-resident of Canada is subject to a statutory withholding rate of 25%. This statutory rate can be reduced if a tax treaty exists between Canada and the foreign country. For example, the tax treaty between Canada and the U.S. provides for a withholding tax rate of 10% on non-exempt interest and 15% on dividend income received by a U.S. resident from Canadian sources. See Appendix 1 for a table that outlines the withholding tax rates on interest and dividends applicable for non-residents investing in Canada. Note that this table also applies to Canadian residents investing abroad.

The withholding of tax on Canadian investment income varies depending on the type of investment income and the issuer of the investment. Exempt investments are noted below.

CANADIAN INTEREST INCOME

Interest Income – rules effective starting January 1, 2008

Effective January 1, 2008, the Income Tax Act was amended to **eliminate Canadian non-resident withholding tax on all interest payments made to arm's length non-residents**, regardless of their country of residence. Arm's length refers to relationships between entities and/or individuals who are unrelated.

The interest exemption will not apply to:

- payments of interest to related parties (exception for government or government guaranteed debt), or
- certain "participating interest" amounts from Canadian sources paid to a non-resident where interest is contingent or dependent on the use or production from property in Canada or that is computed by reference to revenue, profit, cash flow, commodity price or any other similar criterion or by reference to dividends paid or payable.

Interest Income – rules prior to January 1, 2008

Prior to 2008, there were already many Canadian issued interest-bearing investments that were already exempt from Canadian non-resident withholding tax. **The interest paid on the following investments continues to be exempt from withholding tax if paid to a non-resident under the new rules.**

Canadian government debt obligations (issued after April 15, 1966):

- issued by the federal, provincial or municipal governments; regardless of term.
- guaranteed by the government of Canada (includes strip coupons where the underlying bond is government guaranteed and NHA mortgage-backed securities) regardless of term.

Other exempt debt obligations:

- issued by a corporation which is at least 90% owned by a province or municipality (issued after April 15, 1966); regardless of term.
- corporate bonds where the corporation is in no way obliged to pay more than 25% of the principal amount within 5 years of the date of issue (bond must have been issued after June 23, 1975). Bond does not have to be held for 5 years.
- Guaranteed Investment Certificates (GIC) with a term 5 years or greater.
- Deposits (Term Deposits, GICs, Bank Accounts, etc.) of any term issued by a prescribed financial institution and payable in non-Canadian currency.

The statutory 25% withholding tax rate is still applied to payments to related (non-arm's length) non-residents unless a tax treaty is in place, allowing for a lower rate.

Please note that regardless of the withholding tax exemption for investments listed above, the investment income earned may be subject to taxation in the home country based on local tax laws. Furthermore, foreign country securities laws may not allow its residents to purchase some of the above investments through an account located in Canada.

CANADIAN DIVIDEND INCOME

There are no exemptions from withholding tax on Canadian source dividend income. Therefore, the Canadian non-resident withholding tax on dividends from Canadian corporations is 25% unless reduced by a tax treaty. See Appendix 1 for specific tax treaty rates.

CANADIAN CAPITAL GAINS

Generally, there is no tax withheld on recognized capital gains (such as on the sale of Canadian stocks, bonds, and mutual funds).

An exception is that withholding tax must be paid on the proceeds from the sale of "Taxable Canadian Property" (such as Canadian real estate). The rate of Canadian withholding tax is 25% of the gross proceeds on the sale of the Canadian real estate property. However, if the non-resident seller informs the Canada Revenue Agency (CRA) of the sale within 10 days of the sale date, then the non-resident needs to pay only 25% of any capital gain realized on the sale or post equivalent security with the CRA.

The sale of Canadian real estate requires the non-resident to file a non-resident Canadian income tax return reporting only the taxable capital gain or loss on the sale. Any overpayment of tax will be refunded and any underpayment of tax must be paid by April 30 of the year following the sale.

DISTRIBUTIONS FROM CANADIAN-BASED MUTUAL FUNDS AND INCOME TRUSTS

In general, distributions from Canadian-based mutual funds and income trusts are subject to a 25% non-resident withholding tax unless a tax treaty is in place allowing for a lower rate.

Distributions after March 22, 2004 that are derived from gains related to the sale of taxable Canadian property (e.g., Canadian real estate and Canadian resource properties) may now be subject to a 25% non-resident withholding tax unless lowered by a tax treaty. This change was put in place so that non-residents investing in taxable Canadian property through a Canadian-based mutual fund or income trust could now have similar tax treatment to those investing directly in taxable Canadian property. However, if less than 5% of the total taxable capital gain distributions were paid to non-residents of Canada, then there will be no non-resident withholding tax on the taxable Canadian property capital gains distribution.

Capital gain distributions that are not related to the sale of taxable Canadian property are generally exempt from Canadian non-resident withholding tax

Return of capital distributions

Starting in 2005, return of capital distributions on mutual funds and income trusts that are listed on a prescribed stock exchange are subject to a flat 15% non-resident withholding tax but only if more than 50% of the fair market value of the mutual fund or income trust is attributable to Canadian real estate, Canadian resource properties or a timber resource property.

There are rules in place that will allow some or all of the 15% non-resident withholding tax on return of capital distributions to be recouped if the mutual fund or income trust is later sold at a loss.

RSP/RIF WITHDRAWALS

There are many Canadians who have accumulated RSPs/RIFs in Canada and have moved or are planning to move abroad. The amount of Canadian non-resident withholding tax will depend on which vehicle the funds are withdrawn from and how large a withdrawal is made.

For residents of most countries including the U.S., withdrawals of any amount from an RSP will be subject to a 25% non-resident Canadian withholding tax.

For many countries that Canada has a tax treaty with, including the U.S., any withdrawals from a RIF will be subject to a 15% non-resident withholding tax only if payments from the RIF during a calendar year are less than the greater of:

i) twice the minimum withdrawal required for the year; or

ii) 10% of the fair market value of the RIF at the beginning of the year

One notable exception is RIF payments made to residents of the United Kingdom. If payments from the RIF during a calendar year are made to a resident of the UK and are less than the greater of:

i) twice the minimum withdrawal required for the year; or

ii) 10% of the fair market value of the RIF at the beginning of the year,

there will be no withholding tax on the payments made.

The Canada Revenue Agency (CRA) has deemed the value of the RIF at the beginning of the first year to equal the value of the RSP at the time of conversion to a RIF for non-residents only. This will allow the non-resident to apply part ii) in the formula stated above, in order to receive the reduced treaty rate on RIF withdrawals in the first year.

Since LIF/LRIF/PRIF minimum payments are based on RIF minimum payments under the Income Tax Act, the non-resident withholding tax on LIF/LRIF/PRIF withdrawals are identical to RIF withdrawals for a particular country.

Withdrawals from a RIF/LIF/LRIF/PRIF by a resident of a country with which Canada does not have a tax treaty would be subject to a Canadian withholding tax of 25%.

Note that all or a portion of the RSP/RIF/LIF/LRIF/PRIF withdrawal may also be taxed in the foreign country of residence based on their own tax laws. As previously mentioned, a foreign tax credit may be allowed by the foreign country of residence for the Canadian withholding tax in order to avoid double taxation of these amounts.

For more country-specific non-resident withholding rates on RSP/RIF withdrawals please see Appendix 2.

CANADIAN TAX FILING REQUIREMENTS FOR NON-RESIDENTS

Other than the sale of Taxable Canadian Property as previously mentioned, if the payor withheld the correct amount of non-resident tax from the relevant Canadian source income then the non-resident does not need to file a Canadian income tax return with the CRA reporting this Canadian source income. However, if the non-resident discovers that the amount of non-resident withholding was understated based on the statutory and/or tax treaty rates, then the non-resident should voluntarily send the appropriate amount of tax to the CRA (International Tax Services Office) with a letter explaining the payment.

NON-RESIDENTS WHO PURCHASE U.S. INVESTMENTS THROUGH AN ACCOUNT IN CANADA

QUALIFIED INTERMEDIARY

Effective 2001, the U.S. Internal Revenue Service (IRS) implemented changes to its non-resident withholding tax rules by introducing new documentation requirements regarding the U.S. or non-U.S. status of investors. One of the primary objectives of the new rules is to improve the integrity and fairness of the process of claiming reduced rates and exemptions from U.S. non-resident withholding tax for non-U.S. resident investors.

Most non-U.S. financial institutions including the Canadian legal entities within RBC have contracted with the IRS to become a Qualified Intermediary (QI). As a QI, Canadian RBC legal entities can withhold non-resident U.S. tax on U.S. source income received by investors at preferential rates, provided appropriate personal client documentation is on file. Without appropriate documentation, investors may be subject to punitive U.S. non-resident withholding tax on income from U.S. securities rather then the reduced rates available through statutory exemptions or tax treaties.

The following information assumes that the investor is not a U.S. citizen or U.S. resident and has provided the necessary personal documentation under the QI requirements to qualify for any applicable exemptions or reduced rates of U.S. non-resident withholding tax.

DIVIDENDS FROM U.S. CORPORATIONS

The default U.S. non-resident withholding tax on dividends from U.S. companies is 30%. However, if the investor is a resident in a country that has a tax treaty with the U.S. and the account is properly documented under QI, then the U.S. non-resident withholding tax may be reduced. For example, investors who are residents of Canada, Australia, France, Germany, Japan and the United Kingdom are generally subject to a U.S. non-resident withholding tax of 15% on dividends from U.S. corporations.

If the investor is a resident of a country which does not have a tax treaty with the U.S. or if the client account is not properly documented under QI, then there will be U.S. non-resident withholding of 30% on dividends from U.S. corporations. For example, some of the countries that do not have tax treaties with the U.S. are Hong Kong, Taiwan, Singapore, Bermuda, Bahamas, Turks and Caicos to name a few. Investors resident in these countries will be subject to the default U.S. non-resident withholding tax of 30% on U.S. source dividends.

Refer to Appendix 3 for a table of the U.S. non-resident withholding tax rates on U.S. source dividends depending on where the investor resides.

INTEREST FROM U.S. ISSUERS

The default U.S. non-resident withholding tax on interest paid on U.S.-issued debt obligations is 30%. This default rate applies to the interest on debt obligations issued by U.S. governments or U.S. corporations. This default non-resident withholding tax rate may be reduced if the investor is resident in a country that has a tax treaty with the U.S and the account is properly documented under QI. However, regardless of where the investor is resident there will generally be no U.S. non-resident withholding tax on U.S. source interest classified as "portfolio interest". One way to qualify for the portfolio interest exemption is if the following two criteria are met:

- The debt obligation must have been issued after July 18, 1984; and
- The client account must be documented properly under QI.

CAPITAL GAINS FROM U.S. INVESTMENTS

Generally, there is no tax withheld on capital gains realized on the sale of U.S. securities such as on the sale of U.S. stocks and U.S. bonds. However, there may be U.S. withholding tax of 35% on capital gain distributions from U.S.-based REITs.

INCOME FROM ADRS

ADRs (American Depositary Receipts) are negotiable certificates issued by a U.S. commercial bank (the "depositary") and represent ownership in a stated number of non-U.S. company shares. ADRs trade on U.S. stock exchanges.

Since ADRs are not shares of U.S.-based companies, QI is not relevant. RBC is generally not responsible for deducting the appropriate U.S. withholding tax on income from non-U.S. based companies such as ADRs. A foreign intermediary is responsible for charging the appropriate withholding tax on income from ADRs. The exact withholding tax on income from ADRs will depend on the tax laws of the country of the underlying ADR shares and whether this country has a tax treaty with the investor's country of residence.

APPENDIX 1 – INTEREST & DIVIDEND WITHHOLDING RATES (JAN 2008)

The following table outlines the withholding rate applicable for non-residents of Canada receiving Canadian source investment income. In general, the terms of most tax agreements result in the same withholding rate being applied by both countries. For example, Canada applies a 15% withholding rate to dividend income paid to U.S. residents and vice versa. In addition, many of the treaties have unique exceptions and qualifications on withholding tax that cannot be listed in a table such as this. Therefore for final confirmation, the particular treaty should be consulted when determining whether or not there is withholding tax required on a specific payment. **Furthermore, it is possible that the actual withholding tax rates are lower than those indicated in the table due to the payor country's domestic tax laws being more favorable than the treaty rate.**

Note that this table is not an exhaustive list of all the countries with which Canada has a tax treaty.

Country with which Canada has a tax treaty	Exempt Interest (a) (%)	Non-Exempt Interest (%)	Dividend (%)
Australia	0	10	15
Barbados	0	15 (b)	15
Belgium	0	10	15
China (does not apply to Hong Kong residents)	0	10	15
Denmark	0	10	15
Egypt	0	15	15
Finland	0	10	15
France	0	10	15
Germany	0	10	15
India	0	15	25
Ireland (Southern)	0	10	15
Israel	0	15 (b)	15
Italy	0	15	15
Japan	0	10	15
Korea	0	10	15
Malaysia	0	15	15 (b)
Mexico	0	10	15
Netherlands	0	10	15
New Zealand	0	15	15
Norway	0	10	15
Philippines	0	15 (b)	15
Russia	0	10	15
Singapore	0	15 (b)	15
Spain	0	15 (b)	15
Sweden	0	10	15
Switzerland	0	10	15
Ukraine	0	10	15
United Kingdom & Northern Ireland	0	10	15
United States	0	10	15

a) Effective January 1, 2008, most interest payments made to non-residents of Canada are exempt from withholding tax. Specifically, Canadian non-resident withholding tax has been eliminated on all arm's length interest paid to non-residents, regardless of their country of residence.

b) This rate applies provided the payment is taxable in the Treaty country; otherwise the rate is 25%.

APPENDIX 2 – RSP/RIF WITHHOLDING RATES (AS OF JANUARY 2008)

The following table outlines the Canadian non-resident withholding tax rates by country on RSP/RIF withdrawals. The withholding taxes in the RIF withdrawal (%) column only apply if the withdrawal criteria mentioned previously in the article are met. For final confirmation, the particular treaty should be consulted when determining the amount of withholding tax required, if any, on a specific payment. Note that this table is not an exhaustive list of all the countries with which Canada has a tax treaty.

Country with which Canada has a treaty	**RSP withdrawals (%)**	**RIF Withdrawals (%)**
Australia	15	15
Barbados	25	15
Denmark	25	25
Dominion Republic	25	18
Finland	25	20
France	25	25
Germany	25	15
Hungary	25	15
Indonesia	25	15
Ireland (Southern)	25	15
Israel	25	15
Italy	25	15 (a)
Jamaica	25	25
Kenya	25	15
Malaysia	25	15
Mexico	25	15
Netherlands	25	15
New Zealand	25 (a)	15 (a)
Norway	25	15
Poland	25	15
Spain	25	15
Switzerland	25	15
Trinidad and Tobago	25	15
United Kingdom and Northern Ireland	25	NIL
United States	25	15

(a) may be further reduced

APPENDIX 3 – U.S. NON-RESIDENT WITHHOLDING TAX ON U.S SOURCE DIVIDENDS (AS OF JANUARY 2008)

The following table outlines the U.S. non-resident withholding tax rates on U.S. source dividends for various countries that an investor may be resident in. Note that there is no U.S. non-resident withholding tax for U.S. source interest eligible for the portfolio interest exemption as discussed in the article.

Country of Residency	**U.S. Non-Resident Withholding Tax on U.S. Source Dividends (%)**
Australia	15
Barbados	15
Canada	15
China	10
Denmark	15
Finland	15
France	15
Germany	15
Greece	30
Italy	15
Jamaica	15
Japan	10
Korea	15
Mexico	10
Spain	15
Sweden	15
Switzerland	15
Taiwan	15
United Kingdom	15