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Taxation: Canadians Investing in the U.S. and Abroad

Withholding and income tax considerations for the Canadian investor

With Canada representing only a small percentage of the world's economy, and with the current strength in the Canadian dollar, more and more Canadians are investing in the U.S., and in other foreign countries to purchase real estate or diversify their portfolios. As a result, a general understanding of the tax issues including withholding tax associated with such investments, or the requirement to file a foreign income tax return is important.

A foreign country's domestic tax rules that govern withholding and income tax vary from country to country. Canada may have a tax treaty with the foreign country, which may alter the withholding tax or income tax that otherwise applies. As a Canadian resident investor, you should always consider your exposure to withholding tax and other foreign income tax prior to making investments outside of Canada. However, it is your after-tax yield (i.e. after considering Canadian and foreign taxes) that determines how many dollars are left over that can be spent or reinvested - which is important.

Since many Canadians diversify their portfolios by investing in the United States, this article will illustrate some of the more common types of U.S. investments and the general U.S. and Canadian tax implications taking into consideration the Canada - U.S. Income Tax Convention (the tax "Treaty").

You may also refer to quick reference tables provided in the appendix of this article. Appendix A provides a summary of the U.S. withholding taxes for common U.S. investments and Appendix B provides a summary of the withholding tax rates on interest and dividends earned in certain foreign countries based on the tax treaty Canada has with that country.

Note: This article assumes that you are an individual who is a resident Canadian for tax purposes (not a corporation or trust, unless otherwise noted), who is not a U.S. citizen or green card holder. This article does not discuss U.S. estate tax issues that may apply to Canadians with U.S. investments. However, you can ask your RBC advisor for a copy of a separate article on U.S. estate tax issues for Canadians. The following information is based on the tax law in effect as of the date of this article. The article is for information purposes only and should not be construed as legal or tax advice. Please consult with your legal and tax advisors before taking any action based upon the information contained in this article.

Foreign Withholding Tax

To determine the amount of withholding tax that a Canadian resident taxpayer may have to pay on income from foreign investments, you must generally consider the following four issues:

- i) Your country of residence (i.e. Canada) for tax purposes;
- ii) The tax laws of the foreign country where the investment is issued;
- iii) Whether a tax treaty exists between your country of residence (Canada) and the foreign country; and
- iv) The type of investment income being earned.

Avoiding Double Taxation

Canadian tax laws require residents of Canada to report their worldwide income. In order to avoid having foreign source income taxed twice (i.e., taxed in the foreign country and then taxed in Canada), Canadian tax laws generally allow you to claim a foreign tax credit on your Canadian income tax return for taxes paid to foreign jurisdictions, including either foreign withholding tax (where that is the only tax you are required to pay) or income tax paid on a foreign tax return where one is required to be filed in the foreign country. By claiming a foreign tax credit for tax paid to a foreign country, your taxes payable in Canada are generally reduced and double tax may be avoided. Note that Canada will only allow a foreign tax credit for taxes paid up to the reduced treaty rate even if a higher rate of tax was paid.

Qualified Intermediary

Many non-U.S. financial institutions, including the Canadian legal entities affiliated with Royal Bank of Canada (collectively, “RBC”) may have contracted with the IRS to become a Qualified Intermediary (QI). As a QI, Canadian RBC affiliates 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, which generally includes completed Form W-8BEN *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding*. Without appropriate documentation, income from U.S. investments may be subject to the U.S. domestic tax rate such as a flat 30% U.S. non-resident withholding tax rate rather than a reduced tax rate available through U.S. domestic tax laws or the Treaty, and Canada will only permit a foreign tax credit up to the reduced Treaty tax rate.

Types of U.S. Investments and Taxation

The following sections discuss the taxation of income received from common types of U.S. investments. The information assumes that the necessary personal documentation under the QI requirements has been completed to qualify for any applicable exemptions or reduced U.S. foreign withholding tax rates. You may also refer to Appendix A for a quick summary of the U.S. withholding taxes for common U.S. investments.

U.S. Interest Income

U.S. source interest earned by Canadian investors is generally exempt from U.S. withholding tax as it may qualify as “portfolio interest” under U.S. domestic tax rules or may be exempt under the tax Treaty. The portfolio interest exemption eliminates U.S. withholding tax requirements on common types of interest-generating investments such as interest from U.S. federal and corporate debt obligations issued after

July 18, 1984, U.S. state and municipal bonds, and interest on bank deposits in the U.S. The tax Treaty (with changes that came into effect on January 1, 2008) eliminates U.S. withholding tax on U.S. source interest that does not qualify as portfolio interest. For example, the Treaty eliminates withholding tax on debt obligations issued before July 18, 1984, which do not qualify under the portfolio interest exemption. In cases where the portfolio interest exemption or the Treaty does not apply, a 10% withholding tax may apply.

Interest earned on Canadian bank and brokerage accounts located in Canada that are denominated in a foreign currency are not subject to foreign taxes. All interest income is subject to Canadian tax at your marginal tax rate. Even if you do not receive a tax slip, you are required under Canadian tax laws to report all your interest income earned.

Interest income earned from non-U.S. foreign governments: Generally, interest income on Eurobonds and some foreign government debt obligation is exempt from withholding tax. Also, interest income from debt obligations issued by Macro-organizations such as the World Bank and Inter-American Development Bank (IADB) is generally exempt from withholding tax. However, the requirements to determine if the interest income from a particular Macro-organization or foreign government debt obligation is exempt from withholding tax must be assessed for each individual issuer.

U.S. Dividend Income

Under the Treaty, a 15% withholding tax generally applies to U.S. source dividends received from U.S. corporations. However, withholding tax generally does not apply to dividends received from most U.S. preferred shares. You should confirm the withholding tax requirement with your tax advisor before investing in U.S. preferred shares. Since U.S. dividends are not paid from Canadian corporations, these dividends do not qualify for the preferential Canadian dividend tax treatment. Foreign dividends are subject to tax at your marginal tax rate like interest income and you can claim a foreign tax credit to reduce or avoid double taxation.

Dividends from shares of Canadian public companies traded on a U.S. stock exchange will generally not be subject to U.S. non-resident withholding tax as they are not considered U.S. source. Dividends from Canadian public corporations are considered Canadian dividends regardless of what stock exchange they trade on. For example, shares of RBC and Bell Canada, which trade on both the Toronto Stock Exchange and the New York Stock Exchange, pay Canadian dividends. These dividends will be eligible for the dividend tax credit on your Canadian income tax return, even if these shares were purchased on a U.S. stock exchange.

U.S. Capital Gains

Withholding tax is normally not withheld on capital gains recognized on the sale or redemption of shares of a U.S. corporation. The capital gain or loss is taxable in Canada and would receive the same beneficial tax treatment that the sale of Canadian shares would receive (i.e. 50% capital gains/losses inclusion rate).

Corporate Actions

Certain types of corporate actions (i.e., takeovers, mergers, spin-off, etc.) involving shares in the U.S. and other foreign corporations may be considered to be non-taxable for Canadian tax purposes. Every corporate action is unique and the tax implications for Canadian residents should be investigated prior to the event occurring and prior to any action being taken with respect to the security. For example, if you have a foreign spin-off, ask your RBC advisor for our article that discusses the tax implications of foreign spin-offs and the special rules that would make the spin off non-taxable for Canadian tax purposes if certain criteria are met.

U.S. Real Estate

For U.S. tax purposes, the ownership of a U.S. vacation property does not require income tax return reporting provided it is not also used as a rental property. However, any disposition of such a property does require a U.S. tax return filing and U.S. capital gains taxation.

U.S. Rental Income: If you derive income from a rental property located in the U.S., the gross rental income is generally subject to a flat 30% U.S. withholding tax rate. However, you may choose to file a U.S. non-resident income tax return and elect to be taxed on the net rental income basis (i.e. gross rental income less expenses such as mortgage interest, property taxes, utilities and repairs).

For Canadian tax purposes your net rental income must be reported on your Canadian tax return and is subject to tax at your marginal tax rate. A foreign tax credit can be taken on your Canadian return for U.S. taxes paid to avoid double taxation.

Sale of U.S. Real Estate: When you sell U.S. real estate, unless the purchaser is paying less than US\$300,000 and is planning to use the property as a personal residence, the purchaser is required to withhold 10% of the purchase price and remit it on your account to the IRS. If your actual U.S. tax liability will be substantially lower than the 10% withholding tax rate you can apply to the IRS for a certificate that will allow the vendor to reduce the withholding to the actual tax that will be due. Whether withholding tax is remitted to the IRS or not you are required to file a U.S. tax return to report the capital gain or loss on the U.S. real estate sold. For property held greater than 12 months, the maximum U.S. capital gain tax rate is 15%, otherwise U.S. graduated tax rates apply and the highest marginal tax rate is 35%. The capital gain or loss must be reported on your Canadian return and receives the same beneficial tax treatment (i.e. 50% capital gains/loss inclusion rate). The property may also qualify for the Canadian principal residence exemption.

If you invest in the U.S. real estate market, ask your RBC advisor for a copy of our article on owning or renting property located in the U.S., where the taxation of U.S. rental income and sale of U.S. real estate are discussed in more detail.

American Depository Receipts (ADRs)

ADRs also known as ADSs – American Depository Shares or GDRs – Global Depository Receipts are negotiable certificates issued by a U.S. commercial bank and represent ownership in a stated number of underlying non-U.S. equity securities. Although ADRs are registered with the U.S. Securities Exchange Commission, are quoted in U.S. dollars and income is paid in U.S. dollars by the depository, they are not considered U.S. source income and thus are not subject to U.S. tax reporting or withholding tax for non-US persons. ADRs are considered foreign equities and dividends are subject to withholding tax at rates that vary according to the country in which the company is incorporated. Due to the administrative process of how dividends are paid from foreign equities, the other country's domestic foreign withholding tax rate, (which may be higher), may be withheld instead of the reduced treaty tax rate. Since Canada will limit the foreign tax credit to the tax treaty rate the excess foreign tax paid may be considered as a cost of the investment and should be considered when evaluating the rate of return. If the ADR is held within a registered account such as an RRSP or other non-taxable account, you will not be able to claim a foreign tax credit for the tax withheld by the other country on your Canadian income tax return. As a result, the total income received is the net dividend after withholding tax is removed. You may want to consider the merits of investing in high capital appreciation ADRs instead of high yield ADRs where this issue arises. Ask your RBC advisor for an article on ADRs which discusses these issues in more detail.

ADR dividends are not eligible for the dividend tax credit and they are not considered Canadian dividends; therefore, they are subject to tax at your marginal tax rate.

There is no withholding tax on sale of an ADR; however, you may trigger a capital gain or loss that must be reported on your Canadian tax return using the 50% capital gain/loss inclusion rate.

U.S. Real Estate Investment Trusts (REITs)

A U.S. REIT will generally distribute either dividends or capital gains. Under the tax Treaty, ordinary dividend distributions made to Canadian resident investors will be eligible for a reduced withholding rate of 15% where one of the following conditions are satisfied:

- a) The investor is an individual (including an estate or testamentary trust that acquired the REIT as a consequence of the individual's death,) and holds an interest of less than 10% of the REIT. Note: for estates and trusts the 15% rate only applies for a period of five years following the death of the individual.
- b) The REIT stock is publicly traded and the beneficial owner (e.g., individual or corporation) holds not more than 5% of any class of the REIT's stock.
- c) A person holds not more than a 10% interest in the REIT and the REIT is diversified. A REIT is considered diversified if the gross value of no single interest in real property exceeds 10% of the REIT's total interest in real property.

(Note that investors who are not properly documented for QI who receive ordinary dividend distributions from U.S. REITs may be subject to a 30% withholding tax instead of 15%).

The withholding rate on capital gain distributions from a U.S. REIT will also be 15% provided the Canadian investor owns 5% or less of the class of stock at any time during the year when the distribution is received and the REIT is listed on a U.S. stock exchange where the REIT stock is regularly traded. Otherwise the non-resident withholding tax on capital gain distributions will generally be 35%.

U.S. withholding tax generally does not apply on the sale or redemption of a U.S. REIT; however, where the interest in the REIT is considered to be a real property interest withholding tax may apply in certain cases. A discussion of these rules is beyond the scope of this article and investors should consult with their tax advisors regarding the tax consequences of their particular REIT investment.

Similar to U.S.-based mutual funds, any capital gain distributions from U.S. REITs will be taxable as foreign income on your Canadian tax return at marginal tax rates and will not be eligible for the 50% capital gain inclusion rate. However, the capital gain or loss on the disposition of the U.S. REIT itself will qualify for the 50% capital gain/loss inclusion rate. A Canadian investor may claim a foreign tax credit on their Canadian tax return to reduce or avoid double taxation.

U.S. Exchange Traded Fund (ETF)

A U.S. ETF may pay interest, dividends or capital gains distributions. A 15% withholding tax rate applies to dividends and capital gains distributed by the ETF. There is currently no withholding tax on interest income earned or capital gains resulting from the sale of your ETF. However, starting in 2012 a 15% withholding tax is expected to apply to interest income if no further legislation is enacted.

Many U.S. ETFs may qualify as a Regulated Investment Company (RIC), which may be set up as a corporation paying U.S. dividends or capital gains distributions. The capital gains may be considered long term capital gains (i.e., where the investment in the RIC was held for more than 12 months) or short term capital gains. Ordinary dividend distributions are subject to a 15% U.S. withholding tax. Capital gain dividend distributions representing net long term capital gains are not subject to U.S. withholding tax. Prior to 2005 and after 2011, short-term capital gains are subject to a 15% U.S. withholding tax.

From January 1, 2005 to December 31, 2011, a U.S. ETF that is an RIC is able to classify certain dividend distributions as being “interest related dividends” or “short term capital gains”. What this means is that no U.S. withholding tax will apply to interest related dividends or short term capital gains where a Canadian investor has less than 10% interest in an RIC. However, starting in 2012, interest related dividends and short term capital gains dividends will be subject to a 15% withholding tax.

For Canadian tax purposes, all U.S. ETF distributions are considered fully taxable foreign income and will be subject to tax at your marginal tax rate. The disposition of a U.S. ETF may trigger a capital gain or loss that will qualify for the 50% capital gains inclusion rate. Note that U.S. capital gains distributions by the U.S. ETF do not receive the 50% capital gains inclusion rate for Canadian tax purposes like they do for Canadian mutual funds. A foreign tax credit can be claimed on your Canadian income tax return to minimize or avoid double tax.

Contrast to Canadian-Based Mutual Funds investing in the U.S.: Capital gains distributions received from Canadian mutual funds that invest in the U.S. are reported on a T3 or T5 tax reporting slip and will qualify for the 50% capital gain/loss inclusion rate. Other U.S. source income including U.S. dividend income received by the Canadian mutual fund will be reported as “foreign, non-business income”, which will be taxable at your marginal tax rate. Any non-resident taxes withheld on dividends and interest earned by the mutual fund will also be flowed out to you. You can claim a foreign tax credit to minimize or avoid double taxation.

U.S. Limited Partnerships

If you make an investment in a U.S. partnership including a U.S. Master Limited Partnership or Limited Liability Companies that elect to be treated as a partnership, you are generally required to file a non-resident U.S. personal income tax return annually. The reason for this is that the partnership may be carrying on a trade or business effectively connected with the U.S. and each non-U.S. partner is treated as if they too are carrying on a trade or business located in the U.S.

Any U.S. source income received during the year that is effectively connected with the U.S. may be subject to non-resident withholding tax equal to the top U.S. marginal tax rate which is 35%. Any excess U.S. withholding tax may be recovered when you file the annual non-resident U.S. tax return.

As a Canadian resident, this U.S. limited partnership income must also be reported on your Canadian tax return. However, from a Canadian tax reporting perspective, unless the limited partnership is targeted towards Canadian investors, there may be difficulty in obtaining adequate information to properly file a Canadian tax return. The information provided by the U.S. limited partnership, using U.S. Form 1065 (Schedule K-1) for limited partner tax reporting, typically lacks sufficient detail to allow the taxpayer to convert the income from a U.S. tax basis to a Canadian tax basis. With the cooperation of the partnership, these difficulties may be overcome, but will typically increase the complexity and cost of your personal tax return.

To minimize or avoid double taxation, a foreign tax credit may be claimed on your Canadian tax return. However, if the partnership is held in a registered account such as an RRSP or other non-taxable account, you will not be able to claim a foreign tax credit on your Canadian income tax return for any U.S. withholding or income tax paid.

U.S. Investment Income Earned in a Canadian Registered Account

Under the tax Treaty, there is a special exemption from U.S. withholding tax on interest and dividend income received from U.S. investments held inside a trust set up exclusively for the purpose of providing retirement income (i.e. RRSP, RRIF, LIRA, LIF, LRIF, and Prescribed RRIF). However, certain types of U.S. investments held in an RRSP are not protected by the Treaty and will be subject to foreign withholding tax. Also, if the income from the investment requires you to file a tax return in the foreign country you cannot claim foreign tax credit on a Canadian return for any foreign income tax paid. For example, U.S. limited partnerships distributing income referred to as “dividends” are subject to U.S. withholding tax since the income received is generally not considered dividend income. Also, you may have a U.S. income tax liability resulting from the requirement to file a U.S. non-resident income tax return.

There are also certain types of financial products that you may use to invest in U.S. securities that are not protected by the Treaty. For example, income from U.S. investments held in a Registered Education Savings Plan (RESP) or Tax-Free Savings Account (TFSA) do not qualify for the Treaty exemption for U.S. non-resident withholding tax since the primary purpose of an RESP is to provide benefits for education and not for retirement and a TFSA is not considered to be exclusively set up for the purpose of providing retirement income. You may consider investing in U.S. investments that produce income which is not subject to U.S. withholding tax such as U.S. preferred shares.

Foreign investments in registered accounts in countries other than the U.S.: Other countries that Canada has tax treaties with do not have the same special treaty exemption available in the Canada-U.S. tax treaty, therefore, interest and dividends received in your registered account from investing in non-U.S. securities may be subject to foreign withholding tax and the total income received will be an amount net of the withholding tax. Since you will not be able to claim a foreign tax credit on your Canadian income tax return where foreign tax is withheld in your registered account, you should consider the net after tax return when making investment decisions. For example, dividends or interest income earned in your registered account from investing in an ADR is not considered U.S. source income so foreign withholding tax may apply and you will not be able to claim a foreign tax credit on your Canadian income tax return.

U.S. Investment Income Earned by a Non-Taxable Organization

Under the Treaty, U.S. investment income earned by an organization that is normally not taxable in Canada (i.e. religious, scientific, literary, educational or charitable organization) may be exempt from U.S. non-resident withholding tax.

Canadian Tax Reporting of Foreign Income

Under Canadian tax rules, you must report all income denominated in a foreign currency in Canadian dollars. You may receive interest, dividends, capital gains distributions, capital gains dividends, or other income denominated in a foreign currency. The type of tax reporting slip you receive may depend on how the investment is held. For example, U.S. securities held personally by a U.S. paying agent may issue a U.S. 1042-slip or for U.S. partnerships a Schedule K-1. If the investment is held in nominee name with a Canadian broker, the tax reporting information may be contained on a T3 or T5 slip which would include any foreign tax withheld.

There are Canadian tax rules requiring foreign denominated income to be converted to Canadian dollars. Investment income earned in a foreign currency may be converted to Canadian dollars using the applicable exchange rate on the date the income was received or the average exchange rate for the tax year. For capital gains and losses resulting from the redemption or sale of foreign securities, the proceeds and adjusted cost bases of the securities must be converted to Canadian dollars using the applicable exchange rates on the settlement dates for all purchases and sales. As a result, your capital gain or loss may be impacted by foreign exchange gains or losses due to fluctuations in the foreign exchange rate. Ask your RBC advisor for an article on currency tax reporting, which explains the tax reporting requirements for cash and various types of securities held in foreign currencies, including what is to be converted, when it is to be converted and at what exchange rate.

Canadian Information Reporting of Foreign Assets

The Canadian government requires all Canadian residents to report foreign assets if the total cumulative cost of these foreign assets exceeds \$100,000 Canadian at any time during the year on Form T1135. Ask your RBC advisor for an article on foreign reporting requirements in Canada for a more detailed discussion.

Conclusion

When determining the merits of investing in foreign securities, in addition to income, capital appreciation potential, and fluctuation in currency exchange rates, you should also consider the foreign tax that may apply and your ability to claim a full foreign tax credit on your Canadian income tax return. Where a full foreign tax credit cannot be obtained you must consider this an additional cost of the investment, which will affect your rate of return. Remember, it is your after-tax yield (i.e. after considering Canadian and foreign taxes) that determines how many dollars are left over that can be spent or reinvested. Speak to your RBC advisor and your tax advisor for assistance.



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APPENDIX A - Common U.S. investments and related U.S. withholding taxes

U.S. investment	Type of income and U.S. withholding (assumes QI documented)
U.S. government or corporate bonds	Interest – 0%
Shares of U.S. corporations	Dividend – 15% Capital gain on sale – 0%
Shares of Canadian corporations traded on a U.S. exchange	Dividend – 0% Capital gain on sale – 0%
American Depository Receipts	No US withholding. Withholding rate is as set by foreign country where underlying corporate issuer originates. May be higher than treaty rate. Capital gain on sale – 0%
Exchange Traded Fund (ETF) traded on a U.S. exchange	1. ETF qualifies as Regulated Investment Company (RIC): <ul style="list-style-type: none"> • Qualified interest income: 0% * (15% starting January 1, 2012 unless further legislation is passed) • Dividend – 15% 2. ETF does not qualify as RIC – Interest / Dividend – 15% Capital gain on sale – 0%
U.S. REITs *	Dividend and capital gain distributions – 15% Capital gain on sale* – 0%
U.S. Master Limited Partnerships (MLPs)* and U.S. Limited Liability Companies (LLCs)* (if LLC elects to be treated as partnership)	Effectively connected income – 35%. U.S. non-resident tax return required to be filed.

* Tax treatment may vary depending on investment's tax status. Verify tax treatment with your tax advisor.

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APPENDIX B - WITHHOLDING TAX RATES (effective June, 2011)

Common countries Canada has a tax treaty with	Interest (%)	Dividend (%)
Australia	10	15
Barbados	15	15
Belgium	10	15
Brazil	25	25
China (does not include Hong Kong)	10	15
Czech Republic	10	15
Denmark	10	15
Egypt	15	15
France	10	15
Germany	10	15
Greece	10	15
India	15	25
Ireland	10	15
Israel	15	15
Italy	15	15
Japan	10	15
Korea	10	15
Malaysia	15	15
Mexico	10	15
Netherlands	10	15
New Zealand	15	15
Norway	10	15
Philippines	15	15
Poland	15	15
Russia	10	15
Singapore	15	15
Slovak Republic	10	15
South Africa	10	15
Spain	15	15
Sweden	10	15
Switzerland	10	15
Thailand	15	15
United Kingdom	10	15
United States	0	15

- These withholding tax rates for Canadian residents are based on the tax treaty between Canada and the foreign country
- Many tax treaties may have unique exceptions and qualifications to qualify for the treaty-reduced rate so you must consult the actual tax treaty to confirm application of the reduced treaty rate
- If foreign countries have a lower domestic tax rate, the lower rate may apply
- If a tax treaty does not exist, the foreign country's domestic tax rate applies, which may be a higher rate
- This table is not an exhaustive list of the countries with which Canada has a tax treaty