

Jason Baba Wealth Management Group Newsletter



Views and opinions
for the clients and friends of

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Taxation: Canadians Investing in the U.S.

Withholding and Income Tax Considerations for the Canadian Investor

With Canada representing only a small percentage of the world's economy, 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.

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"). Note: This article assumes that you are not a U.S. citizen and that you are a resident of Canada for tax purposes.

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.

Qualified Intermediary

RBC Dominion Securities is recognized by the Internal Revenue Service as a Qualified



RBC Wealth Management
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Intermediary (QI). Therefore, we 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.

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.

1) 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. However, please note that 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.

2) U.S. Dividend Income

Under the Treaty, a 15% withholding tax generally applies to U.S. source dividends received from U.S. corporations held in a non-registered account. 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.

3) 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).

4) 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. 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.

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

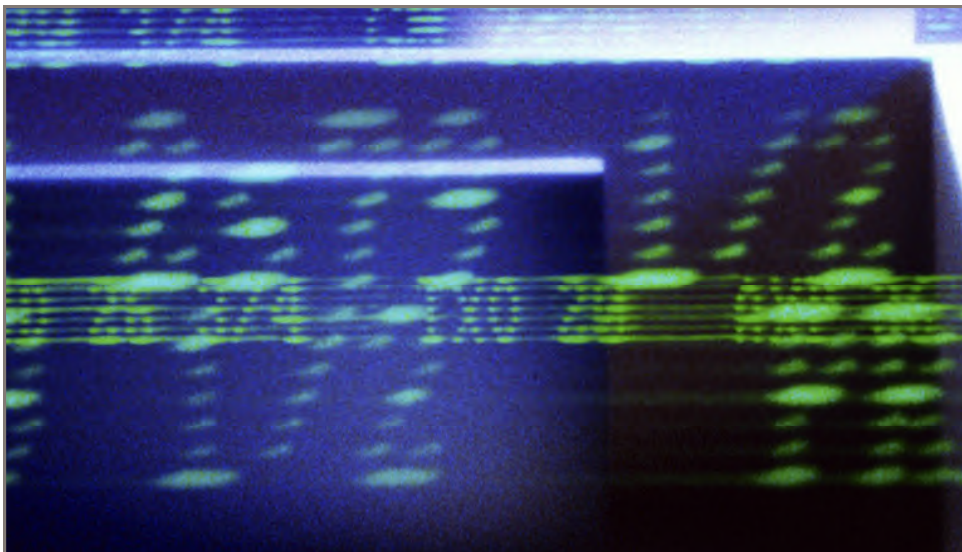
Under the tax Treaty, there is a special exemption from U.S. withholding tax on interest and dividend income received from U.S. investments held inside a trust set up exclusively for the purpose of providing retirement income (ie. RRSP, RRIF, LIRA, LIF, LRIF and Prescribed RRIF).

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.

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.

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