Wealth Management

RBC Wealth Management Services

Investment Advisor
aaron.fennell@rbc.com
416-313-6397

RBC Dominion Securities Inc.
181 Bay Street, Suite 2350
Toronto, ON M5J 2T3
www.aaronwfennell.com
866-605-3295

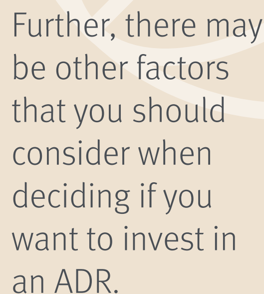
Taxation of foreign equities and ADRs

Foreign withholding tax can impact the return on your foreign equity investments

Canada has tax treaties with many countries that provide for a lower withholding tax rate on the dividends paid to Canadian residents. However, the treaty rate is not always applied. In some cases, due to the foreign country's domestic tax rules, the correct treaty rate may not be used to determine the withholding tax on your investments. Therefore, you may find that sometimes you pay more tax than expected on the foreign equity dividends you earn. Though generally modest in terms of overall impact, it is important that you have a clear understanding of the incremental costs related to investing in foreign equities.

This article discusses the taxation of foreign equities that are shares of companies outside of Canada and the U.S. that you hold either directly or indirectly through an American Depository Receipt (ADR).

This article outlines strategies, not all of which will apply to your particular financial circumstances. The information is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax advisor before acting on any of the information in this article.



Further, there may be other factors that you should consider when deciding if you want to invest in an ADR.

Foreign dividends

Generally, the payor of foreign dividends is obligated to withhold taxes according to the tax rules of the country where the foreign company is incorporated. Due to the administrative process of how dividends are paid from foreign equities, the country's domestic foreign withholding tax rate may be used instead of a reduced treaty tax rate. Often times, the domestic withholding tax rate is significantly higher than the treaty tax rate which is typically no higher than 15%. Please see Appendix 1 for a list of domestic withholding tax rates of various countries.

Dividends paid through ADRs

ADRs and similar foreign securities are generally held in bulk by foreign custodians on behalf of underlying individual owners. These custodians do not have access to information on who the underlying owner is or their residency and thus cannot withhold taxes on dividends at the applicable treaty rate. Therefore, they pay the dividend less the domestic withholding tax.

For example, most of the ADR securities at RBC are held in custody by the Depository Trust Corporation (DTC) in New York. When a foreign dividend is paid to DTC, they simply pass on the net amount they receive from the paying agent which was subject to tax at the full withholding tax rate.

Impact on investment decision

If you are investing in ADRs, you may pay withholding tax in excess of the treaty rate. However, the effect of this excess on the overall return on portfolio may be minimal. Depending on the ADR, there may be no excess withholding tax. See Appendix 2 for an example of the effect of non-resident withholding tax on our "RBC Guided Portfolio: ADR."

Further, there may be other factors that you should consider when deciding if you want to invest in an ADR. These factors may include the size of your portfolio, your desired level of diversification, and your personal preference related to the level of control over the individual securities in your portfolio. It is important to consider all of these factors when you make your investment decision.

Recovering excess withholding tax

Canadian foreign tax credit

As a Canadian resident, you are required to report the gross foreign dividend (before withholding tax) on your Canadian income tax return and pay tax at your marginal tax rate. Canadian tax rules allow you to claim a foreign tax credit for foreign withholding tax paid to alleviate double taxation. However, the rules limit the foreign tax credit that can be claimed to the tax treaty rate on the foreign dividend income. Let's go through an example to illustrate the impact of reporting foreign dividend income on a Canadian tax return and then claiming a foreign tax credit of 15%.

Assume you are resident in Canada with a marginal tax rate of 45%. You earn foreign dividends of $1,000 in

Due to the foreign tax credit limit, some foreign equity dividends may be ultimately taxed at a global tax rate that is higher than your normal marginal tax rate.

your non-registered account during a tax year. You have no other foreign source income during the year. The treaty withholding tax rate on the foreign dividend is 15%. The following table compares the overall tax impact if the actual foreign withholding tax was 25% instead of 15%.

If Canadian tax rules allowed you to claim the full $250 withholding tax as a foreign tax credit, then you would only pay $200 of tax to the Canada Revenue Agency (CRA) ($450 Canadian tax payable - $250 foreign tax credit). However, due to the foreign tax credit limit, you would end up paying $300 in Canadian taxes plus the $250 withheld. Therefore, the global tax rate would be 55%.

The example illustrates that if the withholding tax was equal to or less than the treaty rate, then you would pay a global tax rate equal to your marginal tax rate of 45%. However, if the actual withholding tax is more than the treaty rate, your global tax rate would be higher than your marginal tax rate.

Due to the foreign tax credit limit, some foreign equity dividends may be ultimately taxed at a global tax rate that is higher than your normal marginal tax rate. As such, when evaluating the merits of investing in foreign equities, you should consider the effect of the actual foreign withholding tax that will be applied in determining your investment return.

Canadian income tax deduction for foreign withholding tax

You may be able to take a special income tax deduction on your Canadian income tax return for foreign withholding taxes paid in excess of the treaty rate (generally 15%). In our example above, the special deduction would be for the excess foreign withholding tax of $100 ($250 - $150).

If this deduction can be claimed, your net Canadian taxable income would

	15% treaty withholding tax rate	25% actual withholding tax rate
Gross foreign dividends paid	$1,000	$1,000
Non-resident withholding tax (A)	$150	$250
Gross foreign income reported on Canadian tax return	$1,000	$1,000
Canadian tax payable @ 45%	$450	$450
Foreign tax credit (limited to 15%)	($150)	($150)
Net Canadian taxes payable (B)	$300	$300
Total foreign & Canadian taxes payable (A) + (B)	**$450**	**$550**
Net income	**45%**	**55%**

When you hold foreign equity within a registered or locked-in retirement plan (e.g., RRSP, RRIF, LIRA LIF, LRIF, PRIF), there may still be withholding tax on the dividend income you earn from foreign equities.

decrease to $900 ($1,000 foreign income - $100 special deduction) and the total Canadian tax payable would be $255 ($900 x 45% - $150 foreign tax credit). In this case, the global tax paid would be $505 ($255 to the CRA and $250 withholding tax on the foreign income). Although less than the $550 of total tax in the earlier example, it's still more than if only 15% of foreign tax was withheld (or $450). Why? In general, a tax deduction at marginal tax rates is not as beneficial as a foreign tax credit which reduces you taxes payable dollar for dollar.

The CRA has stated that they consider foreign withholding tax in excess of the treaty rate to be a "voluntary payment" and not an "income tax" and thus they may disallow this special Canadian income tax deduction. Therefore, you should discuss this issue with a qualified tax advisor before attempting to claim this deduction on your Canadian tax return.

Recovering withholding tax from foreign jurisdiction

The process to recover the excess foreign withholding tax is complex and problematic. In some circumstances, resolution could take years and there is a history of low success rates in reclaiming excess withholding tax. You will need to obtain the applicable reclaim forms from the local Embassy or Tax Agency of the country of the equity issuer's origin. After completing the forms, you will need to arrange to have the CRA and your broker certify them. You would then submit these forms along with any other required documents to the foreign Embassy or Agency.

Forms, timeframes, success rates, and requirements vary greatly from jurisdiction to jurisdiction. Although some countries have a process to handle the recovery requests, there is generally no guarantee that your application will be successful. In addition, you may need to pay fees as part of the reclaim process. There may also be other fees charged by the custodian if a claim is initiated through them.

Foreign dividends earned in registered plans

When you hold foreign equity within a registered or locked-in retirement plan (e.g., RRSP, RRIF, LIRA LIF, LRIF, PRIF), there may still be withholding tax on the dividend income you earn from foreign equities. You have no ability to claim a foreign tax credit on your Canadian income tax return for the withholding tax applied to your dividend income in a registered plan. As a result, the income you earn on the foreign investment is the net dividend. Therefore, if you purchase foreign equities in your registered plan you should consider the net after-tax return.

ADRs versus the underlying foreign equity

When compared to buying foreign securities directly, ADRs generally offer a number of compelling advantages to Canadian investors, specifically:

- Lower transaction and custodian fees;
- Greater visibility, with access to live pricing data and quotation in U.S. dollars;
- Payment of dividends or interest in U.S. dollars;
- Familiar trade, clearance, and settlement procedures;
- Greater analyst coverage; and
- Greater access to information due to stricter U.S. disclosure requirements.

If excess withholding tax is an issue, you may want to consider the merits of investing in high capital appreciation ADRs instead of high yield ADRs.

While ADRs offer the above advantages, the outstanding market capitalization on some ADR issues may be smaller. This means that the ADR may be less liquid than the underlying shares and there may be some tracking error in the price of the ADR relative to the underlying share. However, there are also cases where the ADR market is more liquid than the underlying foreign market. Speak with your RBC advisor for more information regarding liquidity of a particular ADR and underlying share market.

Foreign equities held through mutual funds

The issue of excess withholding tax on foreign dividends can also affect those holding foreign equities in a pooled form such as a mutual fund or an exchange-traded fund (ETF). In the case where the equities are held in a fund, the foreign dividend payor may not be able to identify the underlying unit holders and therefore will apply the domestic withholding rate.

Sale of foreign equities

Generally, there is no withholding tax on the sale of foreign equities or the sale of an ADR. You may trigger a capital gain or loss on the sale. You will need to report this capital gain or loss on your Canadian tax return. This gain or loss is eligible for the 50% capital gain or loss inclusion rate. This means that half of the gain or loss is taxable to you.

If excess withholding tax is an issue, you may want to consider the merits of investing in high capital appreciation ADRs instead of high yield ADRs. This will allow you to eliminate or minimize the amount of withholding tax that you will be subject to and benefit from the preferential tax treatment of capital gains. However, there may be higher risks associated with capital appreciation ADRs. Speak with your RBC advisor about your risk tolerance and whether this strategy makes sense for your portfolio.

Conclusion

If you are thinking about investing in foreign equities either directly or indirectly through ADRs, you should be aware of the foreign withholding tax that may apply. The withholding tax rate that applies to the dividends you receive may be greater than expected which will affect your after-tax return. However, the impact of the higher foreign withholding taxes on an overall portfolio is generally modest. There may be more important factors for you to consider. Speak to your RBC advisor for assistance on building your portfolio. If you require more information regarding the taxation of your investments, speak with your qualified tax advisor.

Appendix 1 – Domestic non-resident withholding tax rates for select countries

Country	Domestic withholding tax rate	Treaty withholding tax rate
Australia	0% / 30%*	15.00%
Belgium	25%	15.00%
Brazil	0%	25.00%
Chile	35%	15.00%
Denmark	15% / 27%**	15.00%
Finland	20%	15.00%
France	30%	15.00%
Germany	26.375%	15.00%
India	0%	25.00%
Israel	4% / 15% / 25%***	15.00%
Italy	26%	15.00%
Japan	15.32%	15.00%
Netherlands	15%	15.00%
South Korea	22%	15.00%
Spain	21%	15.00%
Sweden	30%	15.00%
Switzerland	35%	15.00%
United Kingdom	0%	15.00%

* The default withholding tax rate is 30% on dividends. However, if the dividend is “franked”, no withholding tax is applied. When a dividend is “franked”, tax has already been applied before the dividend is paid to the shareholder.

** The default withholding tax rate on dividends is 27%. However, the rate is 15% where the recipient holds less than 10% of the payer company and the tax authorities in the recipient’s country of residence is obligated to exchange information with Danish tax authorities under a tax treaty or other international treaty.

*** The default withholding tax rate is 25% on dividends paid to a non-controlling shareholder (owns less than 10% of the payor company). The withholding rate may be reduced to 15% or 4% depending on the type of enterprise that is paying the dividend.

Appendix 2: Impact of excess withholding tax on performance of securities of Guided ADR Portfolio

The following table compares the actual withholding tax rate applied to dividends paid to Canadians on securities currently in the "RBC Guided Portfolio: ADR" with the applicable treaty withholding tax rate. The treaty withholding tax rate is 15% for most countries with the exception of Brazil which has a treaty rate of 25%. On an individual security basis, the impact on returns may range from zero to approximately 38 basis points, depending upon the country of origin and the relative size of the dividends. When viewed as a portfolio the combined impact is closer to 7 basis points.

Issuer	Country of origin	Price	Dividend	Actual withholding tax rate	Treaty withholding tax rate	Excess withholding tax rate	Relative under-performance
HMC	Japan	$33.30	1.78%	15.32%	15.00%	0.32%	0.006%
WPPGY	UK	$107.93	2.60%	0.00%	15.00%	0.00%	0.000%
BTI	UK	$115.02	4.09%	0.00%	15.00%	0.00%	0.000%
DEO	UK	$122.78	2.61%	0.00%	15.00%	0.00%	0.000%
UL	UK	$44.74	3.30%	0.00%	15.00%	0.00%	0.000%
E	Italy	$51.64	4.66%	20.00%	15.00%	5.00%	0.233%
RDS.B	UK	$84.65	4.25%	0.00%	15.00%	0.00%	0.000%
SNP	China	$88.87	3.93%	10.00%	15.00%	0.00%	0.000%
HSBC	UK	$51.32	4.77%	0.00%	15.00%	0.00%	0.000%
ING	Netherlands	$14.30	0.00%	No Div	15.00%	0.00%	0.000%
KB	South Korea	$34.33	1.10%	22.00%	15.00%	7.00%	0.077%
PUK	UK	$46.19	2.39%	0.00%	15.00%	0.00%	0.000%
FMS	Germany	$34.35	0.97%	26.38%	15.00%	11.38%	0.110%
SNY	France	$53.80	2.45%	30.00%	15.00%	15.00%	0.368%
TEVA	Israel	$48.86	2.28%	15.00%	15.00%	0.00%	0.000%
ERJ	Brazil	$34.40	1.35%	15.00%	25.00%	0.00%	0.000%
NJ	Japan	$14.11	0.62%	15.32%	15.00%	0.32%	0.002%
SI	Germany	$131.83	2.29%	26.38%	15.00%	11.38%	0.260%
ERIC	Sweden	$11.98	2.51%	30.00%	15.00%	15.00%	0.377%
NICE	Israel	$43.20	1.26%	15.00%	15.00%	0.00%	0.000%
SAP	Germany	$80.99	1.72%	26.38%	15.00%	11.38%	0.196%
BBL	Australia	$64.70	3.65%	0.00%	15.00%	0.00%	0.000%
LYB	Netherlands	$92.50	3.30%	0.00%	15.00%	0.00%	0.000%
BT	UK	$62.67	2.44%	0.00%	15.00%	0.00%	0.000%
CHU	China	$15.33	1.68%	10.00%	15.00%	0.00%	0.000%

Weighted average impact on a portfolio with one share of each security: 0.065%

Please contact us for more information about the topics discussed in this article.

This document has been prepared for use by the RBC Wealth Management member companies, RBC Dominion Securities Inc. (RBC DS)*, RBC Phillips, Hager & North Investment Counsel Inc. (RBC PH&N IC), RBC Global Asset Management Inc. (RBC GAM), Royal Trust Corporation of Canada and The Royal Trust Company (collectively, the "Companies") and their affiliates, RBC Direct Investing Inc. (RBC DI) *, RBC Wealth Management Financial Services Inc. (RBC WMFS) and Royal Mutual Funds Inc. (RMFI). Each of the Companies, their affiliates and the Royal Bank of Canada are separate corporate entities which are affiliated. *Members-Canadian Investor Protection Fund. "RBC advisor" refers to Private Bankers who are employees of Royal Bank of Canada and mutual fund representatives of RMFI, Investment Counsellors who are employees of RBC PH&N IC, Senior Trust Advisors and Trust Officers who are employees of The Royal Trust Company or Royal Trust Corporation of Canada, or Investment Advisors who are employees of RBC DS. In Quebec, financial planning services are provided by RMFI or RBC WMFS and each is licensed as a financial services firm in that province. In the rest of Canada, financial planning services are available through RMFI, Royal Trust Corporation of Canada, The Royal Trust Company, or RBC DS. Estate & Trust Services are provided by Royal Trust Corporation of Canada and The Royal Trust Company. If specific products or services are not offered by one of the Companies or RMFI, clients may request a referral to another RBC partner. Insurance products are offered through RBC Wealth Management Financial Services Inc., a subsidiary of RBC Dominion Securities Inc. When providing life insurance products in all provinces except Quebec, Investment Advisors are acting as Insurance Representatives of RBC Wealth Management Financial Services Inc. In Quebec, Investment Advisors are acting as Financial Security Advisors of RBC Wealth Management Financial Services Inc. RBC Wealth Management Financial Services Inc. is licensed as a financial services firm in the province of Quebec. The strategies, advice and technical content in this publication are provided for the general guidance and benefit of our clients, based on information believed to be accurate and complete, but we cannot guarantee its accuracy or completeness. This publication is not intended as nor does it constitute tax or legal advice. Readers should consult a qualified legal, tax or other professional advisor when planning to implement a strategy. This will ensure that their individual circumstances have been considered properly and that action is taken on the latest available information. Interest rates, market conditions, tax rules, and other investment factors are subject to change. This information is not investment advice and should only be used in conjunction with a discussion with your RBC advisor. None of the Companies, RMFI, RBC WMFS, RBC DI, Royal Bank of Canada or any of its affiliates or any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. ® Registered trademarks of Royal Bank of Canada. Used under license. © 2016 Royal Bank of Canada. All rights reserved.NAV0090 (05/16)