Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Tax implications of investing in the United States

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. to 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 U.S. income tax return, is important. This article will illustrate some of the more common types of U.S. investment income and the general U.S. and Canadian tax implications taking into consideration the Canada-U.S. Income Tax Convention ("Treaty"). You may also refer to the Appendix, which provides a summary of the U.S. withholding taxes for common U.S. investments.

This article assumes that you are an individual who is a resident of Canada for tax purposes (not a corporation, non-taxable organization or trust) and are not a U.S. citizen or green card holder. It does not discuss U.S. estate tax issues that may apply to Canadians with U.S. investments. For further information, ask your RBC advisor for a copy of our article on U.S. estate tax for Canadians.

This article outlines several strategies, not all of which will apply to your particular financial circumstances. The information in this article 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.

Foreign withholding tax

When you are investing in foreign securities, including those from the U.S., you may be subject to non-resident withholding tax. To determine the amount of withholding tax that you may have to pay on income from foreign investments, you must generally consider the following:

- Your country of residence (i.e. Canada) for tax purposes;
- The tax laws of the foreign country where your investment is issued;
- Whether a tax treaty exists between your country of residence (Canada) and the foreign country;
- The type of account in which you hold your investment (e.g. registered, non-registered); and
- The type of investment income you are earning.

Avoiding double taxation

As a Canadian resident, you need to report your worldwide income for tax purposes, which includes the gross amount of any foreign income you earn. You must report this income regardless of whether you receive a tax slip for the income. Since you may also be subject to foreign withholding tax, the foreign income you earn may be subject to tax twice. In order to avoid this double taxation, Canadian tax laws generally allow you to claim a foreign tax credit on your Canadian income tax return for taxes paid to foreign jurisdictions. This includes both foreign withholding tax and any income taxes you pay if you have to file a foreign tax return. By claiming a foreign tax credit, you will generally reduce your Canadian taxes payable and may avoid double taxation. Note that Canada will only allow a foreign tax credit for taxes paid up to the reduced treaty rate (if applicable) even if a higher rate of tax was paid.

Reduced rate of withholding under the Canada-U.S. treaty

A reduced rate of withholding tax is generally available to Canadians under the Canada-U.S. Treaty. In order to qualify for the preferential withholding tax rate, you will need to provide proper documentation. This signed documentation is generally a valid IRS 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 which is generally a flat 30% U.S. non-resident withholding tax rate. Note that a signed W-8BEN form is only valid for three years, after which, you will need to provide a new form to continue to receive a preferential withholding rate.

Under the Treaty, there is a special exemption from U.S. withholding tax on interest and dividend income that you earn from U.S. investments through a trust set up exclusively for the purpose of providing retirement income.

U.S. interest and dividend income earned in a Canadian registered account

Under the Treaty, there is a special exemption from U.S. withholding tax on interest and dividend income that you earn from U.S. investments through a trust set up exclusively for the purpose of providing retirement income. These trusts include RRSPs, RRIFs, LIRAs, LIFs, LRIFs and Prescribed RRIFs. They do not include RESPs, TFSAs and RDSPs.

The special exemption is not currently available in any other tax treaty that Canada has with other countries. Therefore, interest and dividends you receive from investing in non-U.S. securities may be subject to foreign withholding tax.

Certain types of U.S. investments you hold in an RRSP do not qualify for the Treaty exemption and will be subject to U.S. withholding tax. For example, if you hold a Canadian mutual fund or ETF that invests in the U.S. market in your RRSP/RRIF, there will be U.S. withholding tax on the dividends that you cannot recover.

Taxation of various types of U.S. investment income

The following sections discuss the taxation of income received from common types of U.S. investments. The information provided assumes that you have completed the necessary personal documentation so that you qualify for any applicable exemptions or reduced U.S. foreign withholding tax rates.

U.S. interest income

"Portfolio interest" as defined under U.S. domestic tax rules is generally exempt from U.S. withholding tax. The portfolio interest exemption applies to many common types of interest, 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 Treaty (with changes that came into effect on January 1, 2008) will generally eliminate U.S. withholding tax on U.S.

interest that does not qualify as portfolio interest. In cases where the portfolio interest exemption and the Treaty do not apply, a 15% withholding tax may apply.

The interest you earn on foreign currency denominations in bank and brokerage accounts located in Canada is not generally subject to foreign taxes.

U.S. dividend income

Under the Treaty, a 15% withholding tax generally applies to U.S. dividends you receive from U.S. corporations. This will generally apply to dividends you receive on U.S. common and preferred shares. However, there are certain types of U.S. preferred shares (e.g. hybrid securities) that are exempt from U.S. withholding tax. 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, U.S. dividends do not qualify for the preferential Canadian dividend tax treatment. Foreign dividends, including U.S. dividends, are subject to tax at your marginal tax rate like interest income.

Dividends from shares of Canadian public corporations that trade on a U.S. stock exchange will generally not be subject to U.S. non-resident withholding tax. 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 preferential dividend tax credit on your Canadian income tax return, even if these shares were purchased on a U.S. stock exchange.

Capital gains on sale of U.S. securities

Withholding tax is generally not withheld on capital gains realized on the sale or redemption of shares of a U.S. corporation. The capital gain or loss is taxable in Canada and will 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-offs, 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 you will need to review the transaction prior to taking any action in respect to the security. For example, if one of the securities you hold is going to have a spin-off, it may not be a taxable event. Ask your RBC advisor for our article on the tax implications of foreign spin-offs.

Under the Treaty, a 15% withholding tax generally applies to U.S. dividends you receive from U.S. corporations.

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. These certificates represent ownership in a stated number of underlying non-U.S. equity securities. ADRs are registered with the U.S. Securities and Exchange Commission, are quoted in U.S. dollars and income is paid in U.S. dollars by the depository. However, the income from these investments is not U.S.-source income. They are not subject to U.S. tax reporting or withholding tax for non-U.S. persons. For information on the taxation of income from ADRs, ask your RBC advisor for our article on the taxation of dividends from foreign equities and ADRs.

U.S. Real Estate Investment Trusts (REITs)

A U.S. REIT will generally distribute either dividends or capital gains. Under the Treaty, you will generally be subject to a withholding rate of 15% on the dividends you receive if you satisfy one of the following conditions:

- The investor is an individual (including an estate or testamentary trust that acquired the REIT as a consequence of an 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.
- The REIT 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.
- 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 REITs total interest in real property.

The withholding rate on capital gain distributions from a U.S. REIT may also be 15%. In order to qualify for the 15% rate, you must own 5% or less of the stock at any time during the one-year period ending on the date you receive the capital gains and the REIT is listed on a U.S. stock exchange where the REIT stock is regularly traded. Otherwise the non-resident withholding tax rate on capital gain distributions will generally be equal to the highest U.S. federal corporate tax rate.

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 gains 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. You may be able to claim a foreign tax credit on your Canadian tax return to reduce or avoid double taxation.

U.S. Exchange Traded Funds (ETFs)

A U.S. ETF may pay interest, dividends or capital gain distributions. A 15% withholding tax rate applies to dividends and capital gains that you receive from the ETF. There is also a 15% withholding tax starting in 2014 on interest income received (in previous years no withholding tax was applied on interest income distributed).

A U.S. ETF may qualify as a Regulated Investment Company (RIC). A RIC may be set up as a corporation that pays U.S. dividends or capital gain distributions. If so, the capital gain distributions may be considered long-term capital gains (i.e., where the investment in the RIC is held for more than 12 months) or short-term capital gains. Ordinary dividend distributions are subject to a 15% U.S. withholding tax. Long-term capital gain distributions are not subject to U.S. withholding tax. Starting in 2014, interest-related dividends and short-term capital gains dividends are subject to a 15% withholding tax (in previous years it was possible for no withholding tax to apply to these types of distributions).

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.

If you invest in a U.S. ETF that earns investment income from outside the U.S., the ETF may be subject to foreign withholding tax in those foreign countries. As an investor in the ETF, you may not be able to recover this tax.

Any U.S. source income you receive 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.

U.S. limited partnerships

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

Any U.S. source income you receive 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. You may be able to recover any excess U.S. withholding tax when you file the annual non-resident U.S. tax return.

As a Canadian resident, you must also report U.S. limited partnership income on your Canadian tax return. However, from a Canadian tax reporting perspective, unless the limited partnership publishes specific information for Canadian investors, there may be difficulty in obtaining adequate information to properly file a Canadian tax return. U.S. limited partnerships typically provide information using U.S. Form 1065 (Schedule K-1) to its limited partners. However, this form generally lacks sufficient detail to allow a taxpayer to convert 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.

If the partnership elects to be treated as a corporation, the dividends you receive may be treated as foreign dividends. The dividends may be subject to a 15% withholding tax as described above in the dividend income section. You may also not have to file a U.S. tax return in this case.

It is important to note that if a foreign investment you hold in your registered account requires you to pay taxes and file an income tax return in the foreign country, you cannot claim a foreign tax credit on your Canadian tax return for

any foreign income tax paid. For example, if you invest in a U.S. limited partnership in your registered account and the partnership elects to be treated as a partnership for tax purposes, you may be subject to U.S. withholding tax. Further, you may have a U.S. income tax liability resulting from the requirement to file a U.S. non-resident income tax return. Therefore, consider holding U.S. limited partnership investments outside of your registered accounts. When you make a withdrawal from your registered plan in later years you will not be able to claim a foreign tax credit on your Canadian income tax return for the U.S. income tax paid in earlier years. This may give rise to double taxation.

Before investing in U.S. partnerships you should consider the U.S. and Canadian income tax impact. Ask your tax advisor for advice.

Reporting foreign income on your Canadian tax return

Under Canadian tax rules, you must report all of the income you earn in Canadian dollars. Ask your RBC advisor for our article on currency tax reporting. This article explains the tax reporting requirements for cash and various types of securities held in foreign currencies.

Canadian information reporting of foreign assets

The Canadian government requires you to disclose information about your foreign assets if you meet certain conditions. For example, if the total cumulative cost of certain foreign assets you hold exceeds C$100,000 at any time during the year, you may be required to disclose these assets on Canada Revenue Agency's Form T1135 – *Foreign Income Verification Statement*. Ask your RBC advisor our article on foreign reporting requirements in Canada for more details.

> 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.

Other considerations

When determining the merits of investing in foreign securities, there are many things you should consider. In addition to income and capital appreciation potential and fluctuations in currency exchange rates, you should also consider the tax implications of the investment. You may be subject to foreign tax and you may be able to claim a full foreign tax credit on your Canadian income tax return. Where you cannot claim a full foreign tax credit, you consider this an additional cost of the investment. It is important for you to consider your after-tax yield (i.e. after considering Canadian and foreign taxes). Speak to your RBC advisor and your tax advisor for assistance in calculating your after-tax yield and evaluating your investments.

APPENDIX – Common U.S. investments and related U.S. withholding taxes

U.S. investment	Type of income and U.S. withholding rate (assumes valid documentation is provided for preferential treaty rates)
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 U.S. 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%
U.S. Exchange Traded Fund (ETF) traded on a U.S. exchange	1. U.S. ETF qualifies as RIC: • Interest related dividends and short-term capital gain distributions 15% starting January 1, 2014 • Dividend – 15% 2. U.S. ETF does not qualify as RIC – Interest, dividend and capital gain distributions – 15% Capital gain on sale of ETF investment – 0%
U.S. REITs[1]	Dividend and capital gain distributions – 15% Capital gain on sale[1] – 0%
U.S. Master Limited Partnerships (MLPs)[1] and U.S. Limited Liability Companies (LLCs)[1] (if LLC elects to be treated as partnership)	Effectively connected income – Top U.S. federal marginal rate. U.S. non-resident tax return required to be filed annually.

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

Wealth Management

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