INTERNATIONAL INVESTING – ADDITIONAL FACTORS THAT CAN TAKE A BITE OUT OF RETURNS

Investing in international equities has a wealth of diversification benefits. A simple and cost-effective way of gaining exposure to these benefits is through exchange-traded funds (ETFs). However, in order for Canadian investors to maximize their return net of taxes, it's important to include the potential impact of foreign withholding tax in the selection process for the best investment solution.

Many countries impose a tax on income paid to foreign investors – whether it's dividend or interest income. While the tax rate can vary from country to country, Canadian investors are generally subject to a 15% withholding tax for dividend payments from U.S. companies. Withholding tax is deducted prior to the receipt of the income and can often go unnoticed by investors. However, if not managed appropriately, it can have a substantial negative impact on returns.

When an investor is looking to minimize withholding tax on an ETF that provides international exposure, it is important to consider two important components: 1)How the ETF is structured and 2) The type of account in which the ETF will be held.

ETF Structure

How an ETF obtains its exposure to international markets can have a significant impact on the amount of withholding tax an investor ultimately pays. Generally, a Canadian investor can gain exposure to international markets through ETFs in one of three ways:

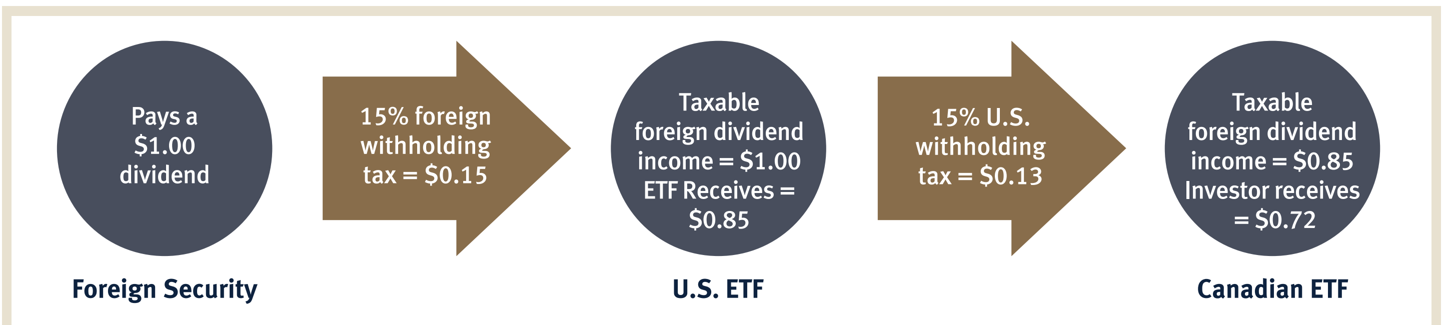
1. A U.S.-listed ETF that invests directly in a portfolio of international stocks.
2. A Canadian-listed ETF that holds a U.S.-listed ETF that invests in a portfolio of international stocks.
3. A Canadian-listed ETF that invests directly in a portfolio of international stocks.

The differences between these three structures are subtle, but striking, when it comes to the amount of withholding tax an investor has to pay.

When an investor holds a U.S.-listed ETF to gain exposure to international stocks, they may be subject to two levels of withholding tax. First, they may be taxed by the country where the foreign stock is domiciled. Second, they may be taxed by the U.S. government when the income is distributed by the U.S.-listed ETF to their account.

Similarly, when an investor owns a Canadian ETF that indirectly gains exposure to international markets by investing in a U.S.-listed ETF (i.e. an ETF of ETFs), they may again be subject to two levels of withholding tax. As shown below, a dividend paid by a foreign security would be subject to foreign withholding tax, as the payment is sent to the U.S. ETF. In addition, a dividend paid by the U.S. ETF would be subject to U.S. withholding tax, as the payment is sent to the Canadian ETF.

Withholding Tax for a Canadian-Listed ETF Investing in a U.S.-Listed ETF to Gain International Equity Exposure



Note: A 15% foreign withholding tax rate was assumed for the purpose of this example. Rates vary from country to country. Depending on the country mix, the ETF's average withholding tax rate may be more or less than 15%.

By contrast, when a Canadian invests in a Canadian-listed ETF that gains exposure to international markets by investing directly in international equities, they may be subject to only one level of withholding tax – by the country where the foreign stock is domiciled. As shown below, a dividend paid by a foreign security would only be subject to one level of withholding tax, as the payment is sent to the Canadian ETF.

Withholding Tax for a Canadian-Listed ETF Investing Directly in International Equities

Note: A 15% foreign withholding tax rate was assumed for the purpose of this example. Rates vary from country to country. Depending on the country mix, the ETF's average withholding tax rate may be more or less than 15%.

Account Type

How an ETF obtains its exposure to foreign equities is only one part of the withholding tax question. The type of account in which an ETF is held is the second important factor in determining the amount of withholding tax a Canadian investor will pay. Different account types are subject to withholding tax in different ways. There are generally three account types an individual investor may hold:

1. **Taxable Account** – Generally, an investor can recover foreign withholding tax paid directly via the "Foreign Tax Paid" box on their T3 or T5 slip. Withholding tax paid indirectly is generally not recoverable.
2. **Registered Account (RSP, RIF)** – These accounts are not subject to U.S. withholding tax due to the Canada-U.S. Tax Treaty, but are generally subject to withholding tax collected by other countries that is not recoverable.
3. **TFSA/RESP** – These accounts are generally subject to withholding tax, regardless of where it is collected. No U.S. withholding tax exemption exists for these accounts.

Understanding the 1) ETF structure and 2) the account type in which the ETF is held are key ingredients that can help an investor minimize withholding tax. The chart to the right summarizes the interaction between the two.

ETF Structure and Account Type Matter

ACCOUNT TYPE	ETF STRUCTURE		
	U.S.- Listed ETF Holding Foreign Stocks Directly	Canadian-Listed ETF Holding Foreign Stocks Indirectly via a U.S. ETF	Canadian-Listed ETF Holding Foreign Stocks Directly
Taxable	U.S. WHT Recoverable Foreign WHT Not Recoverable	U.S. WHT Recoverable Foreign WHT Not Recoverable	Foreign WHT Recoverable
Registered (RSP/RIF)	U.S. WHT Exempt* Foreign WHT Not Recoverable	U.S. and Foreign WHT Not Recoverable	Foreign WHT Not Recoverable
TFSA/RESP	U.S. and Foreign WHT Not Recoverable	U.S. and Foreign WHT Not Recoverable	Foreign WHT Not Recoverable

* U.S. withholding tax does not apply on U.S. dividends earned in an RRSP/ RRIF. WHT = withholding tax.

Other Tax Considerations

While minimizing withholding tax is an important objective, there may be other tax considerations that investors may wish to consider.

U.S. Estate Taxes – High-net-worth investors should be aware of the impact U.S. estate taxes may have on their estate upon their death. For 2014, investors with over US$5.345 million in worldwide gross assets and over US$60,000 in U.S. assets may be subject to U.S. estate taxes, even if they are not U.S. citizens or residents. This can result in significant unanticipated expenses to their estate upon their death. With a maximum tax rate of 40%, it is important to understand which U.S. assets may be subject to the estate tax and if there are ways to minimize (or eliminate) this risk.

Assets such as U.S. real estate, stocks, bonds and units of U.S.-listed ETFs are among those that are subject to the U.S. estate tax, while Canadian-domiciled mutual funds and Canadian-listed ETFs that invest in the U.S. or foreign markets are not. As such, high-net-worth Canadians looking to invest in U.S. or international equities may wish to consider a Canadian-listed ETF as a potential solution that provides similar exposure, but is not subject to the U.S. estate tax.

CRA Foreign Reporting Requirements – As part of Canada's 2013 Federal Budget, the Canada Revenue Agency (CRA) made changes to the Foreign Income Verification Statement (Form T1135), requiring taxpayers to report significantly more detail about their foreign property ownership to the CRA than was previously required. Canadian residents are now required to report their ownership interest in a number of investments that are considered "specified foreign property" if the cumulative costs (rather than market value) exceed C$100,000 at any time during the taxation year.

Specified foreign property generally includes (but is not limited to): shares in foreign companies (even if held in a Canadian investment account), bonds or debentures issued by foreign governments or companies, and interests in or units of foreign mutual funds (including foreign-listed ETFs). Excluded from the reporting requirements are property held in tax-deferred accounts (such as RSPs, RIFs, RESPs, TFSAs and other registered accounts), units of Canadian registered mutual funds (including Canadian-listed ETFs) that invest in foreign securities, and certain personal use and business properties.

Investors may wish to arrange their investment affairs, including the selection of foreign investments such as Canadian-listed ETFs, in such a way as to minimize their reporting obligations on these new foreign reporting requirements.

Putting It All Together

Investing in international equities offers many benefits to an investment portfolio; however, it can also introduce additional complexities that must be understood and considered. By ensuring that these tax considerations are made up front in the decision-making process, investors can maximize their returns while minimizing taxes.

To find out more about RBC ETFs, please contact your financial advisor or visit **rbcgam.com/etfs.**

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