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The impact of withholding taxes on Canadian ETF investors

Note: This guide applies to investors that are classified as Canadian for tax purposes.

Exchange-traded funds (ETFs) are flexible and low-cost investment tools with the potential to provide broadly diversified exposure to both Canadian markets and markets outside Canada.

One aspect of ETF investing that is often misunderstood is the impact of withholding taxes on ETFs that invest in international markets and how this contributes to the total cost of ETF ownership.

Most countries impose withholding tax

Investors should be aware that most countries impose some type of withholding tax on dividends paid to foreign investors, whether the investor is an individual or a fund. The most important factors to consider when quantifying the costs of foreign withholding tax are the underlying holdings and structure of the ETF, as well as the type of investment account in which the ETF is held.

Depending on ETF structure and underlying holdings, investors can be subject to two levels of withholding tax. ETFs listed on Canadian stock exchanges will incur withholding taxes when dividends are paid from the underlying securities to the fund, based on negotiated treaties between the country of origin of the company paying the dividend and Canada.

This first level of withholding taxes is also applicable to U.S.-listed ETFs providing Canadian investors exposure to U.S. equities. Taxes will be withheld when the U.S.-listed ETF pays out a dividend to a Canadian investor.

When stocks are held indirectly through a Canada-listed ETF that invests in a U.S.-listed ETF, 15% of the dividend is withheld by the U.S.-listed ETF. The Canada-listed ETF will receive the dividend net of the withholding tax amount.

Withholding tax is one of many aspects that investors must consider when deciding if an ETF is appropriate for their portfolios. The following illustration provides an explanation of the first and second levels of withholding taxes.

Two levels of tax consideration

When a Canada-listed ETF wraps a U.S.-listed ETF, there are two levels of tax consideration, which are outlined below.

1 — First level
Tax assessed on dividends, interest or capital gains that are distributed from the underlying securities (including shares of other funds or ETFs) to the U.S.-listed (underlying) fund

2 — Second level
Tax assessed on dividends, interest or capital gains that are distributed from the U.S.-listed fund to the Canada-listed fund

Additionally, foreign withholding taxes will be applied differently based on the type of investment account that holds the ETF, including Registered Retirement Savings Plan (RRSP), Tax-Free Savings Account (TFSA), Registered Education Savings Plan (RESP) and taxable accounts. In taxable accounts, investors may be able to recover some of their incurred withholding taxes by using tax credits allotted to them. In RRSP accounts, the use of a U.S.-listed ETF may be beneficial as RRSPs are exempt from certain withholding taxes if the underlying securities are held directly.

The following tables reflect the current tax environment, are for illustrative purposes only and are subject to change. Please consult with a tax advisor for more information.

What fixed income investors should know

In general, U.S. bonds do not levy withholding taxes for non-U.S. shareholders. However, bonds issued in countries other than the U.S. may have withholding taxes on interest (and possibly gains)—however, the rates will vary by the bond issuer's country of origin. This would mirror the first level of withholding taxes seen in equity funds.

Application of withholding taxes by type of investment account:

U.S. equities

Product structure	RRSP		TFSA/RESP		Taxable	
	L1	L2	L1	L2	L1	L2
U.S.-listed ETF (direct)	×	×	√	×	±	×
Canada-listed ETF (direct)	√	×	√	×	±	×
Canada-listed ETF via U.S.-listed ETF	√	×	√	×	±	×

International equities

Product structure	RRSP		TFSA/RESP		Taxable	
	L1	L2	L1	L2	L1	L2
U.S.-listed ETF (direct)	√	×	√	√	√	±
Canada-listed ETF (direct)	√	×	√	×	±	×
Canada-listed ETF via U.S.-listed ETF	√	√	√	√	√	±

√ Withholding taxes will apply

× Withholding taxes will not apply

± Withholding taxes will apply but can be creditable

L1 First level of withholding

L2 Second level of withholding

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All investments are subject to risk, including the possible loss of principal.

Investments in stocks issued by foreign companies are subject to risks including country/regional risk, which is the chance that political upheaval, financial troubles, or natural disasters will adversely affect the value of securities issued by companies in foreign countries or regions; and currency risk, which is the chance that the value of a foreign investment will decrease because of unfavourable changes in currency exchange rates.

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