January 30, 2020

Hidden Taxes on Your US Investments

Our investment strategy has been calling for a significant allocation to US and international stocks for several years now. Investors have been generously rewarded for diversifying into the US markets, as the S&P500, DOW Jones, and Nasdaq have all outperformed the TSX over the past decade. When you live in a country like Canada with a relatively small, poorly diversified stock market, global diversification is extremely important.

We continue to be advocates of owning a basket of globally diversified assets, however we caution investors on how they obtain foreign exposure. Not all structured investments are taxed equally. Investing in US and international markets does carry a price in the form of foreign withholding taxes.

Almost all countries levy a tax on dividends paid to foreign investors. For example, if you're a Canadian holding a US stock in a taxable account, Uncle Sam deducts 15% of your dividends before you receive them. You can typically claim the foreign tax when you file your return. This is only the case when investing in a non-registered account.

With broad-based US index funds now yielding about 2%, the withholding tax amounts to an additional cost of 30 basis points. Some international equity funds are yielding close to 4%, which would be reduced by 60 basis points from withholding taxes. As you can see, the impact of withholding taxes can be far greater than that of management fees, which gets a lot more attention.

The good news is that Canada and the US have a tax treaty that allows investors to avoid this tax if they hold their US investments in an RRSP or RRIF. However, that treaty does not apply to Tax-Free Savings Accounts or RESPs, so if you hold US stock in one of these accounts you will indeed be subject to the withholding tax.

Now, here's where things can get confusing. When a Canadian-listed ETF holds a US-listed ETF (such as XSP, which simply holds IVV), it too is subject to the withholding tax. The dividends are taxed at 15% before they are paid to the Canadian ETF sponsor, and then these reduced dividends are passed on to investors. So, if you hold XSP in any one of your tax-sheltered investment accounts (TFSA, RESP, RRSP, RRIF, LIRA, LIF), you are still getting dinged with the withholding tax, it just happens indirectly.

The fact is, most people are unaware that their dividends are being decreased by the amount of withholding taxes. Because the fund itself is being taxed here, not the individual who holds shares of the fund, the tax treaty does not apply. This is an important consideration that even many investment advisors are clueless about.

This also applies to Canadian mutual funds holding US stocks. US withholding tax of 15% is levied at the fund level and not the individual. Like the example of tax treatment on XSP, if you were to buy the TD US index fund in your RRSP or RRIF, dividends would be taxed at 15% before reaching your pocket. As a fund holder you'd be none the wiser of this taxation inside your RRSP or RRIF.

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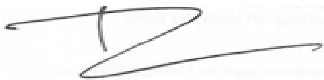
When making investments, investors should consider the type of account and the type of investment vehicle being used. A way to eliminate this double taxation inside the RRSP or RRIF account is to own US listed ETFs, such as SPY. The dividends generated by the holdings are not going though a Canadian ETF or mutual fund sponsor first. Alternatively, investors can own US stock directly through individual holdings.

Investment Type	Account Type		
U.S. Markets	RRSP/RRIF, LIRA/LIF	TFSA, RESP	Taxable account
Canadian Listed Mutual Fund holding US stocks directly	15% Withholding Tax	15% Withholding Tax	15% Withholding Tax, Credit to Canadian Taxes
Canadian Listed ETF holding a US listed ETF of US stocks	15% Withholding Tax	15% Withholding Tax	15% Withholding Tax, Credit to Canadian Taxes
Canadian Listed ETF holding US stocks directly	15% Withholding Tax	15% Withholding Tax	15% Withholding Tax, Credit to Canadian Taxes
Direct US stock holdings	Tax Exempt	15% Withholding Tax	15% Withholding Tax, Credit to Canadian Taxes
US Listed ETF holding US stocks directly	Tax Exempt	15% Withholding Tax	15% Withholding Tax, Credit to Canadian Taxes

Bottom line, Canadian sponsored ETFs and mutual funds that are holding US stocks have an additional tax drag from withholding taxes. This taxation is not avoidable or recoverable when held within an RRSP/RRIF account. This means that you will be taxed 15% before receiving this income, and then taxed again upon withdrawal from the RRSP/RRIF. This in effect is double taxation of the dividend income. We recommend understanding how foreign investment vehicles are taxed and what sort of shelter each type of account provides. In this low interest rate environment, we would prefer to keep 100% of the US dividend income generated in our RRSP/RRIF accounts by avoiding US withholding taxes.

Sincerely,



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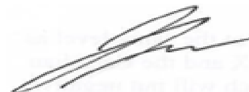

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