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Tax considerations for ETF investors: Foreign withholding taxes on Fixed Income

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Exchange traded funds (ETFs) can be an easy way to gain low-cost exposure to global markets. However, investors purchasing foreign investments through ETFs should be aware of the withholding tax that can occur in some situations. Oftentimes, this tax goes unnoticed since distributions are usually paid after the withholding tax is applied to the ETF and may or may not be reflected on year-end tax slips. An investor holding an ETF will receive any distribution net of the withholding taxes. Foreign withholding tax, the cost of foreign currency exchange as well as management and trading fees are all cost considerations investors should be mindful of.

Our first paper on this topic explained how equity ETFs are taxed by outlining the common structures and account types generally affected by withholding tax. This paper will explain the considerations for the various ways in which investors can access fixed-income exposures.

ETF structures

The amount of withholding tax incurred by the ETF investment is dependent on the structure of the ETF and how that structure gains exposure to U.S. and international fixed income.

The three most common structures available to Canadian fixed-income investors include:

- U.S.-listed ETF that invests in U.S. or international fixed income
- Canadian-listed ETF that holds U.S.-listed ETFs which invest in U.S. or international fixed income
- Canadian-listed ETF that invests directly in U.S. or international fixed income

U.S. and International Fixed-Income Exposure Through U.S.-Listed ETFs

Canadian investors that hold U.S. securities should consider Canadian and U.S. tax implications. For example, a Non-Resident Alien (NRA) may be subject to non-resident withholding tax on any U.S.-source income they earn.

What is a Non-Resident Alien (NRA)?

According to the IRS, if you are not a U.S. citizen, you are considered a Non-Resident Alien (NRA), unless you meet either the green card test or the substantial presence test for the calendar year (January 1-December 31).[1]

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The PATH Act

In 2015, the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) was signed into law. The PATH Act eliminated U.S. withholding taxes on certain dividends paid by U.S.-regulated investment companies (RICs) to Non-Resident Alien (NRA) investors that are reported as Qualified Interest Income (QII).

NRA shareholders are normally subject to a 30% withholding tax, depending on the country and the tax treaty rate on income and short-term capital gain dividends paid by an ETF, unless such dividends are designated as exempt from NRA withholding tax. The withholding tax amount is reduced to 15% for taxable Canadian investors by a tax treaty between the U.S. and Canada.

As a result of the PATH Act, withholding tax does not apply to dividends based on a RIC's QII. This includes:

- Original issue discount on an obligation payable within 183 days of issuance;
- Interest on an obligation in registered form (other than interest on an obligation issued by an obligor in which the RIC is a 10 per cent shareholder, or interest that does not qualify as portfolio interest);
- Interest on deposits; and
- Interest-related dividends received from other RICs and short-term capital gain dividends (dividends based on short-term capital gains realized by a RIC).[2]

U.S. ETF providers typically identify the distributions that are QII and thus exempt from NRA withholding.

As mentioned, non-resident withholding tax is applied to any U.S.-source income earned. However, certain ETFs generate QII and short-term capital gains that may be exempt from U.S. withholding tax when distributed to non-U.S. holders. It is important to note that not every U.S. fixed-income ETF has distributions that qualify as QII. QII varies in different fixed-income exposures like TIPs, government bonds and corporate bonds. QII reporting can be found under tax information on various ETF providers' websites.

The Depository Trust Company's (DTC) U.S. Tax Withholding Service ensures the appropriate NRA withholding tax gets applied on U.S.-source income paid to NRA investors. The applicable withholding tax is determined based on the type of income being paid along with the tax forms provided by the participant. DTC notifies participants of taxable events on their securities held at the depository and informs participants of the "election window" during which they must send withholding rate instructions to the depository. DTC pays distributions to participants on the payable date, net of appropriate withholding tax in accordance with participants' instructions.[3]

Sample calculations of foreign withholding taxes through various ETF structures

1 U.S.-listed ETF that invests in U.S. or international fixed income

Investments in U.S. fixed income through a U.S.-listed ETF would be subject to withholding taxes in the U.S. except if the investments are held in an account that is exempt from U.S. withholding taxes (e.g., RRSP or RRIF accounts).

For other account types, a withholding tax rate of 15% would typically apply to distributions unless the distribution is classified as QII. If the U.S.-listed ETF is applying a fixed withholding tax rate of 15% to all monthly distributions, it would be up to the investor and their advisor to claim a refund of any excess withholding taxes by filing Form 1040-NR with the IRS. This filing requirement can be avoided by investing directly in U.S. fixed income using a Canadian-listed ETF as will be discussed below.

Investments in international fixed income through a U.S.-listed ETF would be subject to foreign withholding taxes based on the tax rules of the country where the investment is issued (which may be reduced based on the foreign country's tax treaty with the U.S., if any) in addition to the U.S. withholding taxes discussed above. International fixed income does not generate QII therefore a refund of U.S. withholding taxes would not be available. The U.S. withholding taxes paid can only be recovered as a foreign tax credit for investments held in taxable accounts. Investors interested in gaining international fixed-income exposure can avoid the U.S. withholding taxes by using Canadian-listed ETFs that invest in international fixed income directly.

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Example 1: iShares Core US Aggregate Bond ETF (AGG)

In 2019, the monthly QII distributions from AGG were between 85.93% and 91.60% of distributions. The total distributions per share were approximately $3.0361 in 2019 of which approximately $2.6804 represented QII distributions. As a result, the total U.S. withholding taxes on non-QII distributions should be approximately $0.05334 for 2019. This represents an average withholding tax rate of approximately 1.76% as a percentage of total distributions, versus the 15% withholding tax rate that may otherwise have applied if the investor did not receive the withholding tax exemption on QII. The annual difference of 13.24% in this example can significantly impact the investor's return from this investment if there is lack of appropriate U.S. tax withholdings/filings.

Example 2: iShares JP Morgan USD Emerging Markets Bond ETF (EMB)

EMB provided a total distribution of approximately $5.17012 per share in 2019. As no portion of this distribution would be classified as QII, U.S. withholding taxes of 15% would have generally applied on this distribution from the U.S.-listed ETF to the Canadian investor. This 15% may not be recoverable by the investor in all situations. To avoid this unfavourable result, the investor can use a Canadian-listed ETF with the same risk and return exposure to international fixed income.

2 Canadian-listed ETF that holds U.S.-listed ETFs which invest in U.S. or international fixed income

Investments in Canadian-listed ETFs that hold U.S.-listed ETFs with U.S. fixed-income exposure would be subject to withholding taxes in the U.S. regardless of which type of account is used in Canada (i.e., the withholding tax exemption available for RRSPs and RRIFs does not apply for investments made through a Canadian-listed ETF). It would be important to understand how the ETF provider is treating any U.S. withholding taxes charged on QII and whether such withholding taxes from being reclaimed from the IRS as appropriate. Any non-QII distributions would be subject to U.S. withholding taxes that may be claimed as a foreign tax credit for investments held in taxable accounts only. Non-QII income generated in tax-deferred (i.e., RRSP, RRIF, RDSP and RESP) or tax-exempt accounts (i.e., TFSA) would not be taxable in Canada in the year U.S. withholding taxes are paid which means the U.S. withholding taxes would never be recoverable. This unfavourable outcome can be avoided using Canadian-listed ETFs that invests in U.S. fixed income directly as discussed below.

Investments in Canadian-listed ETFs that hold U.S.-listed ETFs with international fixed-income exposure would be subject to foreign withholding taxes and U.S. withholding taxes on all distributions as international fixed income would not generate QII. The U.S. withholding taxes are an additional layer of taxes reducing the overall return for the investor without providing any value. These U.S. withholding taxes paid can only be recovered through the foreign tax credit mechanism available for investments held in taxable accounts as discussed above. Again, this punitive tax result can be avoided using Canadian-listed ETFs that invest directly in international fixed income as discussed below.

Example 1: US Aggregate Bond Index ETF (CAD-hedged) (VBU)

In 2019, VBU investors would have received total foreign income distribution of approximately $0.611560 per share. The total foreign taxes paid on this income were approximately $0.011480 which represents an average withholding tax rate of approximately 1.88%. This average withholding tax rate is different from 1.76% calculated above for AGG, i.e., a U.S.-listed ETF with U.S. fixed-income exposure. Although the discrepancy is only 0.12% in this example, it shows that U.S. withholding tax rules may have been applied differently by the dealer/custodian or ETF provider may have interpreted the NRA withholding tax rules on QII distributions differently. This inconsistency can be avoided altogether by investing in Canadian-listed ETFs that provide direct exposure to U.S. fixed income.

Example 2: iShares JP Morgan USD Emerging Markets Bond Index ETF (CAD-Hedged) (XEB)

Similar to the example above, in 2019, XEB distributed total foreign income of $0.89769 per share but there were no foreign taxes withheld. Generally, the foreign income would be subject to foreign withholding taxes and U.S. withholding taxes on all distributions as the foreign investments would not generate QII. It would be important to investigate how the withholding taxes are charged for such investments so that the investor can claim a foreign tax credit against Canadian tax liability where the investment is held in taxable/non-registered accounts. As an alternative, the investor may eliminate these concerns by using Canadian-listed ETFs that invest directly in international fixed income as discussed below.

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3 Canadian-listed ETF that invests directly in U.S. or international fixed income

Canadian-listed ETFs that invest directly in U.S. fixed income would be exempt from U.S. withholding taxes under the U.S. domestic rules and/or the Canada-U.S. tax treaty. This would greatly simplify the tax filing requirements for the investor while providing the same risk versus return opportunity through U.S. fixed-income exposure.

Canadian-listed ETFs that invest directly in international fixed income would be subject to foreign withholding taxes on the distributions. However, there would be no additional layer of withholding taxes and the foreign withholding taxes paid on the distributions may also be recovered through the foreign tax credit mechanism available for investments held in taxable accounts.

To avoid multiple layers of unfavourable withholding taxes and potentially improve the investment experience, investors can use Canadian-listed ETFs that offer similar risk and return exposure to US and global fixed income.

For more information regarding the taxation of U.S.-listed fixed-income ETFs talk to your financial advisor.

[1] https://www.irs.gov/individuals/international-taxpayers/determining-alien-tax-status
[2] https://www.irs.gov/publications/p515
[3] https://www.dtcc.com/settlement-and-asset-services/global-tax-services/us-tax-withholding-services

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