Investors do not earn gross returns. They earn net returns—and the difference is reflected in costs. The most common costs include management fees, fund operating expenses, commissions, bid/ask spreads, market impact, cash drag, and taxes. Some of these costs are more visible than others, but they all impact investment performance, and investors should be aware of them.

Unfortunately, most investors tend to focus only on costs that are both quantifiable and transparent. For example, the management expense ratio (MER) receives a lot of attention because it is quantified, fully disclosed, and significant. Meanwhile, other material costs may easily go unnoticed. This brief discusses the various ways that one of the more obscure costs—foreign withholding taxes—can affect investors.

Dividends received from non-Canadian investments are usually subject to foreign withholding taxes because most countries require tax to be withheld from dividend payments to foreign investors and be remitted to the local government. Although withholding taxes vary by country, 15% is the most common rate. Taxable investors in Canada receive a credit\(^1\) for the amount of foreign taxes paid (up to 15% of dividends), so the tax paid to foreign governments is substantially, if not completely, offset by a reduction in Canadian taxes.\(^2\)

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\(^1\) Provided the fund makes the appropriate designation.

\(^2\) Withholding tax rates vary by country (i.e., some are more and some are less than the typical 15% rate). A maximum foreign tax credit of 15% is applied at the portfolio level, not by country, but if the weighted average withholding tax rate exceeds 15%, then the full amount would not be recovered and some withholding tax would apply.
On the other hand, investors do not receive a refundable credit for foreign taxes paid in their non-taxable accounts such as Registered Retirement Savings Plans (RRSPs). In certain situations, Canadians with non-taxable accounts are effectively taxed on dividends earned from non-Canadian securities.

**FOREIGN SECURITIES HELD DIRECTLY**

Figures 1 and 2 illustrate how foreign dividends flow to investors in a Canadian-domiciled fund that directly holds non-Canadian dividend-paying securities (e.g., a Dimensional fund). As shown in both figures, withholding taxes are applied to dividends paid by non-Canadian stocks. The Canadian fund distributes the remaining dividends to investors. Taxable investors receive a foreign tax credit to offset some or all of the withheld taxes, as indicated by the green shading. Non-taxable investors do not, as indicated by the red shading.

**FOREIGN SECURITIES HELD INDIRECTLY**

Foreign withholding taxes become more onerous and opaque when a US entity stands between a Canadian investor and non-US securities. Two prominent examples are when Canadian investors buy US-listed international equity exchange-traded funds (ETFs) that hold non-US securities, and Canadian-listed international equity “wrap” ETFs. Both scenarios may result in taxes being withheld and remitted twice on the same dividend payment. More important, the additional level of withholding tax cannot be recovered. The following explores these examples in more detail.
US-LISTED INTERNATIONAL EQUITY ETFs
Figures 3 and 4 illustrate how dividends from non-US securities flow to Canadian investors in US ETFs. The first level of tax is withheld on dividend payments from the underlying portfolio to the US ETF. The ETF then distributes these dividends, net of expenses and the first level of withholding taxes, to Canadian investors.

However, as shown in Figure 3, taxes are further withheld in taxable accounts and remitted to the US on the flowthrough of these dividends because the ETF is a US security paying a dividend to a foreign investor—in this case, a Canadian individual. In these accounts, the second level of withholding tax on the dividend payment from the US ETF can be substantially, if not completely, recovered by a foreign tax credit, but the first level of withholding tax on the dividends from the underlying portfolio to the US ETF cannot.

Figure 4 illustrates the dividend flow for a non-taxable account. There is no tax withheld on dividends from a US security in non-taxable accounts, such as RRSPs. However, investors with non-taxable accounts do pay withholding taxes at the first level, when dividends flow from the underlying portfolio to the US-listed ETF.

FIGURE 4:
US-LISTED INTERNATIONAL EQUITY ETF HELD IN A NON-TAXABLE ACCOUNT

**CANADIAN-LISTED INTERNATIONAL EQUITY “WRAP” ETFs**
Figures 5 and 6 illustrate how dividends from non-US securities flow to investors in Canadian “wrap” ETFs. A “wrap” ETF is one that invests solely in a US ETF that holds an underlying portfolio of non-US securities. This structure is commonly used, among others, by international equity ETFs that hedge the Canadian dollar.

The first level of tax is withheld on dividend payments from the underlying portfolio of foreign securities to the US ETF. The US ETF then distributes these dividends, net of expenses and the first level of withholding taxes, to
the Canadian ETF. However, taxes are further withheld and remitted to the US on the flowthrough of these dividends because the ETF is a US security paying a dividend to a foreign investor—the Canadian-listed ETF.

In taxable accounts (Figure 5), the second level of withholding tax on the dividend payment from the US ETF to the Canadian ETF can be substantially, if not completely, recovered by a foreign tax credit, but the first level of withholding tax on the dividends from the underlying portfolio to the US ETF cannot. However, as shown in Figure 6, there is (once again) no refundable credit for foreign taxes paid in non-taxable accounts. So, Canadians with non-taxable accounts are effectively taxed twice when investing in Canadian “wrap” ETFs that hold US ETFs invested in non-US securities.

**FIGURE 5:**
CANADIAN-LISTED INTERNATIONAL EQUITY “WRAP” ETF HELD IN TAXABLE ACCOUNT

**FIGURE 6:**
CANADIAN-LISTED INTERNATIONAL EQUITY “WRAP” ETF HELD IN NON-TAXABLE ACCOUNT

* Not offset by tax credit.

** All or part offset by foreign tax credit.
TABLE 1:
SUMMARY OF WITHHOLDING TAX LEVELS

<table>
<thead>
<tr>
<th>Tax on dividends from underlying portfolio</th>
<th>Taxable Accounts</th>
<th>Non-Taxable Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dimensional Fund</td>
<td>US ETF</td>
</tr>
<tr>
<td></td>
<td>Canadian &quot;Wrap&quot; ETF</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Foreign tax credit</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Tax on dividends from US-listed ETF</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Foreign tax credit</td>
<td>N/A</td>
<td>Yes</td>
</tr>
<tr>
<td>Levels of withholding tax</td>
<td>0*</td>
<td>1</td>
</tr>
<tr>
<td>Additional level of withholding tax</td>
<td>—</td>
<td>1</td>
</tr>
<tr>
<td>vs. a Dimensional fund</td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>Where additional level is applied</td>
<td>—</td>
<td>Foreign-to-US</td>
</tr>
</tbody>
</table>

*Withholding tax rates vary by country (i.e., some are more and some are less than the typical 15% rate). A maximum foreign tax credit of 15% is applied at the portfolio level, not by country, but if the weighted average withholding tax rate exceeds 15%, then the full amount would not be recovered and some withholding tax would apply.

SUMMARY
Table 1 summarizes how withholding taxes apply to international equity investments in both taxable and non-taxable accounts for the three structures discussed.

In certain situations, Canadian investors in US ETFs or Canadian “wrap” ETFs holding non-US securities pay an extra level of withholding tax on dividends relative to investing in products that hold these types of securities directly (e.g., a Dimensional fund).

IMPACT OF DOUBLE TAXATION
Table 2 contains estimates, for illustrative purposes, of the additional tax drag if the extra level of withholding tax applies. The actual amount incurred will depend on the dividend yield of the underlying portfolio and the withholding tax rate being charged.

This extra level of withholding tax is often overlooked because it is buried in the financial statements of the US ETF, or underlying US ETF, rather than being quantified and clearly conveyed like the cost components included in the MER. However, investors should take into account, among other cost considerations, the tax drag of alternative structures rather than simply comparing MERs.

TABLE 2:
ESTIMATED TAX DRAG OF ADDITIONAL LEVEL OF WITHHOLDING TAX*

<table>
<thead>
<tr>
<th>Dividend Yield</th>
<th>1%</th>
<th>2%</th>
<th>3%</th>
<th>4%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Rate</td>
<td>10%</td>
<td>15%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10 bps</td>
<td>20 bps</td>
<td>30 bps</td>
<td>40 bps</td>
<td></td>
</tr>
<tr>
<td>15 bps</td>
<td>30 bps</td>
<td>45 bps</td>
<td>60 bps</td>
<td></td>
</tr>
</tbody>
</table>

* Does not account for the deduction of US ETF expenses against dividend income from the underlying portfolio.