# Tax considerations for ETF investors

# Introduction to foreign withholding taxes

## Foreign withholding taxes

Exchange-traded funds (ETFs) can be an easy way to gain low-cost exposure to international markets. However, Canadian investors purchasing foreign investments through ETFs should be aware that foreign withholding tax may apply in some situations. Oftentimes, this tax goes unnoticed since distributions are usually paid after the foreign withholding tax has been applied to the ETF and may or may not be reflected on investor year-end tax slips.

A Canadian investor investing in an ETF will receive a distribution net of the foreign withholding taxes paid by the ETF. Foreign withholding tax, the cost of foreign currency exchange as well as management and trading fees associated with foreign securities are all cost considerations investors should be mindful of. The following summarizes some of the possible withholding tax considerations of common ETF structures and notes the difference that each account type may have on exemptions or ability to claim foreign tax credits. This will help investors make better-informed decisions when investing in ETFs.

*This material has been prepared for information purposes only. The tax information provided in this document is general in nature and does not constitute tax or legal advice. You should consult with your own tax advisor if you have questions about foreign withholding tax.*

# ETF structures

The amount of foreign withholding tax applicable to an ETF's foreign investments is dependent on many things, including where the ETF is tax resident, and how the ETF gets its exposure to international markets.

The three most common ETF structures that Canadian investors have access to are:

1. US-listed ETF that invests directly in US and international securities;
2. Canadian-listed ETF that invests in a US-listed ETFs, which invests in US and international securities; and
3. Canadian-listed ETF that invests directly in US and international securities.

The summaries below discuss ways in which foreign withholding tax may be applied in each structure. The application and rate of withholding tax is dependent on many factors, including the ability to claim a foreign tax credit and the type of account in which the ETF is held, which are also discussed below. See the chart below to see which accounts may be exempt from certain levels of foreign withholding tax and which may be able to claim a foreign tax credit.

# 1 US-listed ETF that invests in US and international* securities

### International stocks

In this structure, a Canadian investor obtains exposure to international markets indirectly through a US-listed ETF. The Canadian investor in the US-listed ETF may be subject to two levels of foreign withholding tax.

The first level of foreign withholding tax may be applied by the country where the issuer of the stock is resident.

The second level of foreign withholding tax may be applied by the US on distributions from the US ETF to the Canadian investor. In certain accounts, this second level foreign withholding tax can amount to an additional 15%.**

### US equities

If in the same structure the US-listed ETF invests solely in US stocks, the Canadian investor may be subject to one level of foreign withholding tax.

The foreign withholding tax may be applied by the US on distributions from the US-listed ETF to the Canadian investor. In certain accounts, a withholding tax rate of 15%** may apply to distributions.

### US fixed income

In this structure, a Canadian investor obtains exposure to US fixed income securities indirectly through a US-listed ETF.

The Canadian investor may be subject to one level of foreign withholding tax applied by the US on distributions from the US-listed ETF to the Canadian investor. In certain accounts, a withholding tax rate of 15%** may apply to distributions unless the distribution is classified as Qualified Interest Income ("QII") under the applicable US tax rules.

### International fixed income

If in the same structure the US-listed ETF instead invests in international fixed income securities, the Canadian investor may be subject to two levels of foreign withholding tax.

The first level of foreign withholding tax may be applied by the country where the issuer of the security is resident.

The second level of foreign withholding tax may be applied by the US on distributions from the US-listed ETF to the Canadian investor. In certain accounts, a withholding tax rate of 15%** (in addition to the first level foreign withholding tax described above) may apply to distributions. Note international fixed income securities do not generate QII.

# 2 Canadian-listed ETF that invests in US-listed ETFs, which invests in US and internationally

## International stocks

In this structure, the Canadian investor obtains exposure to international markets indirectly through a Canadian-listed ETF that invests in a US-listed ETF, which invests in international stocks. The Canadian investors in the Canadian-listed ETF may be subject to two levels of foreign withholding tax.

The first level of foreign withholding tax may be applied by the country where the issuer of the stock is resident.

The second level of foreign withholding tax may be applied by the US on distributions from the US ETF to the Canadian ETF. In certain accounts, this second level US withholding tax can amount to an additional 15%** (in addition to the first level foreign withholding tax described above).

Dividend from foreign corp. | Foreign withholding tax (15%) | Dividend received by US ETF | US withholding tax (15%) | Dividend received by investor

## US stocks

If in the same structure the US-listed ETF instead invests in US stocks, the Canadian investors may be subject to one level of foreign withholding tax.

The foreign withholding tax may be applied by the US on distributions from the US-listed ETF to the Canadian-listed ETF. A withholding tax rate of 15%** may apply to distributions.

## US fixed income

As above, a Canadian investor obtains exposure to US fixed income securities indirectly through a Canadian-listed ETF that invests in a US-listed ETF, which invests in US fixed income securities.

In this scenario, the Canadian investor may be subject to one level of foreign withholding tax applied by the US on distributions from the US-listed ETF to the Canadian-listed ETF. Investments in Canadian-listed ETFs that hold US-listed ETFs with US fixed-income investments are subject to withholding taxes in the US unless the distribution is classified as QII.

## International fixed income

If in the same structure the US-listed ETF instead invests in international fixed-income securities, the Canadian investor may be subject to two levels of foreign withholding tax.

The first level may be applied by the country where the issuer of the investment is resident.

The second level may be applied by the US on distributions from the US-listed ETF to the Canadian-listed ETF. In certain accounts, this second level US withholding tax can amount to an additional 15%.**

# 3 Canadian-listed ETF that invests directly in US and international securities

## International stocks

In this structure, the Canadian investor obtains exposure to international stocks indirectly through a Canadian-listed ETF.

Unlike the other scenarios, the Canadian investors may only be subject to one level of foreign withholding tax by the country where the issuer of the stock is located.

Dividend from foreign corp. → Foreign withholding tax (15%) → Dividend received by investor

15% foreign withholding tax is used for illustrative purposes.

## US stocks

If in the same structure the Canadian-listed ETF instead invests in US stocks, the Canadian investors may be subject to one level of foreign withholding tax.

The foreign withholding tax may be applied by the US on distributions from the US stocks to the Canadian-listed ETF. A withholding tax rate of 15%** may apply to distributions.

## US fixed income

As above, in this structure a Canadian investor obtains exposure to US fixed income securities indirectly through a Canadian-listed ETF.

In this scenario there should be no foreign withholding tax under the US domestic rules and/or the Canada-US tax treaty.

## International fixed income

If in the same structure the Canadian-listed ETF instead invests in international fixed income securities, the Canadian investor would be subject to foreign withholding taxes by the country where the issuer of the investment is resident.

However, there would be no additional layer of foreign withholding taxes because the investment in international fixed income was made indirectly through a Canadian-listed ETF.

# Foreign tax credits

When an investor receives a distribution from an ETF that is net of foreign withholding tax as described above, the ETF may allocate foreign income and designate the tax to the investor, thus allowing the investor to potentially claim a foreign tax credit on their tax return to recover this foreign tax paid as a reduction of their own taxes payable.

# Canadian investor account types

The type of account that holds the investment also plays a role in determining the amount of withholding tax that is experienced. See the chart below for information on which accounts may be exempt from certain types of foreign withholding tax or may be able to claim a foreign tax credit.

# Withholding tax account type

The following chart provides general information on the foreign withholding tax experienced based on the type of account that holds the ETF.

| | Account type | | |
|---|---|---|---|
| **ETF structure** | **RRSP, RRIF** | **TFSA, RDSP, RESP, FHSA** | **Taxable accounts** |
| **US equities** | | | |
| US-listed ETF holding US equities directly | No US WHT | US WHT on distributions from US ETF | US WHT on distributions from US ETF - tax credit |
| Canadian-listed ETF holding US equities indirectly via a US-listed ETF | US WHT on distributions from US ETF to Cdn ETF | US WHT on distributions from US ETF to Cdn ETF | US WHT on distributions from US ETF to Cdn ETF - tax credit |
| Canadian-listed ETF holding US equities directly | US WHT on distributions on US equities to Cdn ETF | US WHT on distributions on US equities to Cdn ETF | US WHT on distributions on US equities to Cdn ETF - tax credit |
| **US fixed income[1]** | | | |
| US-listed ETF holding US fixed income securities | No US WHT | US WHT on distributions from US ETF | US WHT on distributions from US ETF - tax credit |
| Canadian-listed ETF holding US fixed income securities indirectly via a US-listed ETF | US WHT on distributions from US ETF to Cdn ETF | US WHT on distributions from US ETF to Cdn ETF | US WHT on distributions from US ETF to Cdn ETF - tax credit |
| Canadian-listed ETF holding US fixed income securities directly | No US WHT | No US WHT | No US WHT |

| | Account type | | |
|---|---|---|---|
| **ETF structure** | **RRSP, RRIF** | **TFSA, RDSP, RESP, FHSA** | **Taxable accounts** |
| International[2] equities and fixed income | | | |
| US-listed ETF holding international equities and/ or fixed income securities | Foreign WHT on distributions from international securities | Foreign WHT on distributions from international securities<br>+<br>US WHT on distributions from US ETF | Foreign WHT on distributions from international securities<br>+<br>US WHT on distributions from US ETF - tax credit |
| Canadian-listed ETF holding international equities and/ or fixed income securities indirectly via US-listed ETF | Foreign WHT on distributions from international securities<br>+<br>US WHT on distributions from US ETF to Cdn ETF | Foreign WHT on distributions from international securities<br>+<br>US WHT on distributions from US ETF to Cdn ETF | Foreign WHT on distributions from international securities<br>+<br>US WHT on distributions from US ETF to Cdn ETF - tax credit |
| Canadian-listed ETF holding international equities and/or fixed income securities directly | Foreign WHT on distributions from international securities | Foreign WHT on distributions from international securities | Foreign WHT on distributions from international securities - tax credit |

[1] Assumes income earned is not Qualified Interest Income ("QII"), however see discussion on QII above.
[2] "International" refers to non-Canadian and non-US
"**WHT**" refers to withholding tax.
"**Tax credit**" means that it may be possible to claim a foreign tax credit to recover some, or all of the withholding tax.

Written and published by as a general source of information only. Not intended as a solicitation to buy or sell specific investments, or to provide tax, legal or investment advice. Seek advice on your specific circumstances from your personal advisor(s).

IRS Circular 230 Notice: In compliance with US Treasury Department Circular 230, please note that this information is not intended or written to be used, and cannot be used, by any taxpayer for the purpose of (a) avoiding US federal, state, or local tax penalties, or (b) the promotion or marketing of the transactions or matters addressed herein. The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

# Phantom Distributions

## Year-end phantom distributions

One of the factors that is often overlooked by investors when investing in ETFs through their non-registered accounts is the year-end tax on “phantom distributions”. The following describes what the phantom distributions are and the steps that can be taken to prevent double taxation on ETF units held in non-registered accounts.

Please note this section is not applicable to ETF units held in a registered account (such as RRSPs, RESPs, TFSAs, etc.).

### What are phantom distributions?

When investing in ETFs, investors should be aware of and plan for phantom distributions. To understand what these are, it is important to know how an ETF earns income. ETFs buy and sell securities throughout the year (just like mutual funds), realizing gains and losses on these investments. ETFs can also earn various types of income on its portfolio assets throughout the year, like interest income, dividend income and other income. The realized capital gains are typically distributed annually at the end of the year and immediately reinvested. Distributions of interest, dividends or other forms of income typically occur throughout the year and are paid in the form of cash.

In the books, the annual distribution of capital gains has been paid to the investor, however, the cash that would have been distributed to the investor is instead reinvested and units are immediately consolidated within the ETF. This is where tax will apply to a non-cash ( “phantom”) distribution from an ETF. Fund managers will decide to reinvest distributions as a way to help investors grow their investment without additional commission being incurred. This tax goes unnoticed by most individuals as the phantom distribution is not listed separately as a non-cash distribution on the T3 tax slip. There are two effects as a result of the reinvested distribution. First, in a non-registered account, an investor would pay tax on the phantom distributions similar to receiving a cash distribution. Second, the phantom distribution is added to the adjusted cost base of the ETF units. Double taxation can occur if the investor does not include the phantom distribution when calculating the adjusted cost base and therefore pays more capital gains tax than would otherwise be required.

## Steps to eliminate double taxation caused by phantom distributions to non-registered accounts

1. Determine the amount of the distribution that was reinvested. Since the T3 does not state the amount of the investment that is reinvested into the fund, the unitholder must check on the website of the ETF provider to determine the precise amount.
2. The amount of the reinvestment determined in step 1 should be added (on a "per-unit" basis) to the adjusted cost base (ACB) of the original investment. To obtain the ACB per unit/share, divide the total ACB by the number of units/shares held.
3. The updated ACB will prevent the investor from reporting an excessive capital gain or smaller capital loss upon disposition of the ETF units.

## Adjusted cost base and capital gains/losses for ETFs

To calculate your capital gains or capital losses, you first need to calculate the ACB of your units. The following tables provide a general overview of the ACB and capital gains calculations using a hypothetical example.

| The total of all amounts paid to purchase your securities* | + | The amount of any reinvested distributions | − | The return of capital component of distributions | − | The ACB of any securities previously redeemed | = | **The ACB of your securities** |
|---|---|---|---|---|---|---|---|---|

*including any sales commission paid at the time of purchase
As this is a general overview, please review the prospectus of the ETF for more information on calculating your ACB.

### ACB example transaction

During 2023 an investor purchased $5,000 of Fund A, an ETF at $25.00 per unit for a total of 200 units ($5,000 divided by $25.00).

**Purchase**

Later during 2023, the investor made a second purchase of $5,500 of Fund A at $27.50 per unit for a total of 200 units ($5,500 divided by $27.50).

**Distribution**

On December 31, 2023, the fund paid a notional distribution of $0.30 per unit.

This investor receives a notional distribution of $120.00 (400 units x $0.30). This amount is not received in cash; rather, the investor realizes a reinvestment of this amount by adding to the adjusted cost base of the original investment. After the notional distribution, the adjusted cost base becomes $26.55 ($10,620 divided by 400 units).

**Redemption**

On June 30, 2024, the investor sells 300 units at $31.50 per unit for gross redemption proceeds of $9,450.00.

The adjusted cost base of the 300 units sold is $7,965.00 (300 multiplied by the adjusted cost base per unit of $26.55). The total adjusted cost base of the remaining units is reduced by $7,965.00.

The new total adjusted cost base is $2,655.00. The remaining number of units is 100 and the adjusted cost base remains at $26.55.

## ACB Calculations

| | | Units | Price | Total | ACB per unit |
|---|---|---|---|---|---|
| 1. **Purchase** | 2023 | 200 | $25.00 | $5,000.00 | $25.00 |
| 2. **Purchase** | 2023 | 200 | $27.50 | $5,500.00 | |
| **Total** | | 400 | | $10,500.00 | $26.25 |
| | | | **Price** | **Distribution @ $0.30** | |
| 3. **Notional Distribution** | 31-Dec-23 | | $30.00 | $120.00 | |
| **Total** | | **400** | | **$10,620.00** | **$26.55** |
| 4. **Redemption** | 30-Jun-24 | -300 | $31.50 | -$7,965.00 | $26.55 |
| **Units remaining** | | **100** | **$31.50** | **$2,655.00** | **$26.55** |

The capital gain or loss from the example shown would then be calculated as follows:

| | |
|---|---|
| Proceeds of disposition | $9,450.00 |
| ACB | — ($7,965.00) |
| **Capital gain** | = **$1,485.00** |

## For more information about Mackenzie ETFs or the taxation of US-listed fixed-income ETFs, talk to your financial advisor or visit mackenzieinvestments.com/ETFs

* International refers to non-Canadian and non-US.

** Rate of foreign withholding tax is generally 30%, however assumed to be reduced to 15% under the Canada-US tax treaty.

Commissions, trailing commissions, management fees, and expenses all may be associated with Exchange Traded Funds. Please read the prospectus before investing. Exchange Traded Funds are not guaranteed, their values change frequently and past performance may not be repeated. Index performance does not include the impact of fees, commissions, and expenses that would be payable by investors in the investment products that seek to track an index. The content of this document (including facts, views, opinions, recommendations, descriptions of or references to, products or securities) is not to be used or construed as investment advice, as an offer to sell or the solicitation of an offer to buy, or an endorsement, recommendation or sponsorship of any entity or security cited. Although we endeavour to ensure its accuracy and completeness, we assume no responsibility for any reliance upon it.

This should not be construed as legal, tax or accounting advice. This material has been prepared for information purposes only. The tax information provided in this document is general in nature and each client should consult with their own tax advisor, accountant and lawyer before pursuing any strategy described herein as each client's individual circumstances are unique. We have endeavored to ensure the accuracy of the information provided at the time that it was written, however, should the information in this document be incorrect or incomplete or should the law or its interpretation change after the date of this document, the advice provided may be incorrect or inappropriate. There should be no expectation that the information will be updated, supplemented or revised whether as a result of new information, changing circumstances, future events or otherwise. We are not responsible for errors contained in this document or to anyone who relies on the information contained in this document. Please consult your own legal and tax advisor.

IRS Circular 230 Notice: In compliance with US Treasury Department Circular 230, please note that this information is not intended or written to be used, and cannot be used, by any taxpayer for the purpose of (a) avoiding US federal, state, or local tax penalties, or (b) the promotion or marketing of the transactions or matters addressed herein. The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

3944502 | 04/25