U.S. Withholding Tax Refunds From Pooled Fund Investments

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Many Canadian tax-exempt investors invest in U.S. equities through a standard Canadian pooled fund. This means that they pay the 15 per cent U.S. dividend withholding tax on U.S. equity investments. This can be refunded.

To illustrate, assume that a Canadian charity invests in Apple stock through a standard Canadian pooled fund. When the dividend is issued by Apple to the pooled fund, the 15 per cent U.S. dividend withholding tax is collected by the pooled fund and sent to the U.S. Internal Revenue Service (IRS). However, the charity itself is exempt from the U.S. tax. That means that the charity can claim a refund.

Over a three-year period, the amount of withholding tax paid to the IRS may amount to tens of thousands of dollars or more depending on the size of the U.S. equity investments. Since the tax has already been paid, there is little risk to asking for a refund. The worst the IRS can do is say no. The balance of this article explains the opportunity further.

To start out, consider the different sources of the U.S. tax exemption.

What Canadian Organizations Qualify For The U.S. Tax Exemption?

As outlined below, there are a number of different sources of the U.S. tax exemption and there are different types of Canadian organizations that are eligible for the U.S. tax exemption.

- **Canada U.S. Tax Treaty Tax exemption**

The treaty provides an exemption to U.S. tax to Canadian religious, scientific, literary, and charitable organizations that are exempt from tax in Canada. It also provides a more limited exemption from U.S. tax on dividends and interest to certain legal entities that provide pension, retirement, or employee benefits that are tax exempt in Canada.

- **Tax exemption for governments**

Under U.S. domestic tax law, the Internal Revenue Code (Code) section 892 exempts foreign governments and political subdivisions of those governments from U.S. taxation. In the Canadian context, this means that Canadian federal and provincial governments are exempt from U.S. tax. However, Code section 892 may also extend to other entities including municipalities, First Nations (under either a treaty or the Indian Act), school boards, and other quasi-governmental agencies. Code section 892 also applies to pension funds formed by a governmental organization.

- **General tax exemption for non-profits**

Certain Canadian non-profits fall outside the scope of the treaty tax exemption. For instance, they may not qualify as a charitable organization as they are not a Canadian registered charity. These organizations may, however, qualify under the U.S. domestic tax exemption available to non-profits. Code section 501(c) contains tax exemptions for 27 different types of non-profit entities. Many of these exemptions are available to foreign organizations. In particular, Code section 501(c)(4) applies to non-profit organizations that operate for the "promotion of social welfare." This is a relatively broad category that goes beyond the treaty exemption.

In summary, the following types of organizations in Canada may be eligible for a U.S. tax exemption:

- Educational organizations
- Religious organizations
- Scientific organizations
- Pension, employee benefit, and retirement funds
- Non-profits even if they are not registered charities
- First Nations (either investing through a trust or directly)
- Indigenous investment funds
- Labour unions
- Municipalities
- Conservation authorities
- Other quasi-governmental agencies created by federal or provincial legislation.

Exhibit 1

Magnitude of U.S. Tax Paid

US Equities	3-Year Savings
$2 million	$19,800
$5 million	$49,000
$10 million	$99,000
$15 million	$148,500
$20 million	$198,000

U.S. Tax Refunds On Pooled Fund Investments

Many investors that are eligible for a U.S. tax exemption invest through a pooled fund that pays the dividends withholding tax. There are a number of reasons for this. First, the investment manager may not offer a pooled fund that is exempt from U.S. withholding tax. Second, the pool may be part of a global investment strategy of which U.S. equities are a part and such funds are normally not exempt from withholding tax. Third, a segregated portfolio of U.S. equities, where the portfolio could be exempted from withholding tax, may not be advisable for a number of reasons.

A Canadian organization that invests through a pooled fund that collects the U.S. withholding tax can apply for a refund for three years of taxes paid through the fund. Here is why. Arguably, for both U.S. and Canadian tax purposes, the U.S. dividend withholding tax (although collected and remitted by the fund itself) is allocated to the investor and thus considered paid by the investor.

For Canadian tax purposes, this is true under sections 104(22) and 104(22.1) of the Income Tax Act. For U.S. tax purposes, the technical logic is more complicated. Even though most pooled funds are formed as trusts under Canadian law, they cannot be classified as trusts under U.S. tax law because they have a business purpose. Assuming they meet certain technical criteria, the pooled funds may be partnerships under U.S. tax rules. If so, the withholding tax would be allocated to the investor under U.S. tax law as well. Since the investor does not owe the tax, with the proper documentation it can apply for a refund for the tax paid in the previous three years. That refund could result in reasonable amount of money recovered.

Magnitude Of U.S. Tax Paid

The amount of U.S. dividend withholding tax paid through a pooled fund investment may be surprising. The standard dividend yield in the S&P 500 is 2.2 per cent of the money invested. Of that, 15 per cent is withheld in U.S. taxes. That means that on a yearly basis the dividend withholding tax represents about a 33-basis point cost on the total dollar amount invested in U.S. equities. On a large portfolio this can add up. *Exhibit 1* illustrates the potential recovery over three years based on amounts invested in U.S. equities.

Many Canadian tax-exempt organizations invest in U.S. equities through pooled funds and thus pay the 15 per cent U.S. dividend withholding tax on their U.S. equity portfolios. They can get a refund of this tax for the prior three years and this may amount to tens of thousands of dollars. There are no risks to pursuing these claims because the tax has already been paid and the worst the IRS can do is say no. In difficult economic times, every dollar matters. **BPM**

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