

Withholding Tax on Capital Distributions to Non-Residents

It is generally understood that income distributions by trusts to non-resident beneficiaries are subject to part XIII withholding tax (paragraph 212(1)(c)), but many people are confused about whether to withhold on capital distributions by trusts to non-residents. Such distributions are common in, for example, family trusts where some family members have moved to the United States. (We do not address distributions from mutual fund trusts in this article.)

Although paragraph 212(1)(c) and subsection 212(11) create a withholding tax obligation on certain capital payments, not all capital distributions are caught. If the payment of capital does not fall within the scope of paragraph 212(1)(c), no withholding tax will apply.

- Taxable capital gains distributed to non-resident beneficiaries are subject to part XIII withholding tax because a taxable capital gain is considered income under income tax law, but not under trust law. Thus, in the absence of certain rules in section 212, withholding tax would not apply. However, to protect the Canadian tax base, subsection 212(11) deems any distribution from a trust to a non-resident beneficiary to be a payment of trust income, which causes the imposition of tax under paragraph 212(1)(c). Although subparagraph 212(1)(c)(i) carves out any amount deemed by subsection 104(21) to be a taxable capital gain of a non-resident beneficiary, the carve-out does not apply in this situation because a non-resident beneficiary will not meet the residence requirement in subparagraph 104(21)(b)(ii).
- Capital dividends distributed to non-resident beneficiaries are subject to part XIII withholding tax. Further, any payment to a non-resident beneficiary that is derived from a capital dividend received by the trust is also subject to this withholding tax; thus, trustees must track which trust properties trace their origins to capital dividends. Any payment made by the trust to a beneficiary will be considered income of the trust under subsection 212(11), and therefore subparagraph 212(1)(c)(ii) will apply to subject the amount to withholding tax where it "can reasonably be considered . . . to be a distribution of, or derived from, . . . a dividend on a share of the capital stock of a corporation resident in Canada, other than a taxable dividend."
- Part XIII withholding tax does not apply to distributions of the non-taxable portion of capital gains to non-resident beneficiaries.

Two specialized rules may also apply:

- Certain exemptions from part XIII tax may be available if the conditions in subsection 212(9) are met.
- If the income is designated income as defined in section 210, withholding tax may apply under part XII.2 instead of part XIII.

Although the preceding discussion concerns withholding taxes to be paid by trusts, it is also possible that a non-resident beneficiary may have to pay part I withholding tax. Suppose that a non-resident beneficiary disposes of a capital interest in the trust (for example, by a distribution by the trust of property in satisfaction of that interest) and the capital interest is taxable Canadian property (TCP). TCP is defined to include an interest in a trust where more than 50 percent of the FMV of the interest derives from real or immovable property in Canada. In this situation, withholding tax obligations could arise under section 116. However, the non-resident beneficiary can apply for a certificate of compliance to apply withholding tax only on the net gain rather than on the FMV of the capital interest, which could reduce or eliminate withholding tax altogether.

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