U.S. Withholding Taxes and Aboriginal Investment Portfolios

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Did you know that Aboriginal governments are likely paying taxes to the US government? More important, did you know that most Aboriginal communities and their trusts don't have to? It all depends on how your portfolio is structured. When you invest in US stocks that pay dividends, there is 15% tax withheld at source. That means it never comes into your account but goes directly to the IRS. For Canadian investors who pay tax, you can claim that amount on your tax return so you won't end up paying the taxes twice. However, if you are not paying tax, either because you are tax exempt (the Aboriginal government) or because the income is attributed to the tax exempt Aboriginal government (most FN Trusts), you have nothing to offset against these withholding taxes. So you end up paying tax to the US and have less annual income to invest in important projects.

If you want to pay taxes to the US government, that is fine. If, like most of us, you prefer to not pay taxes that you don't have to, there are strategies to accomplish this. There is some complexity to these strategies, but eliminating US withholding taxes can be achieved. And, in fact, this has been achieved by some Aboriginal organizations.

Section 892 of the US tax code exempts foreign governments (such as Canadian Aboriginal governments) and trusts controlled by those governments from US taxes. Claiming these benefits not only exempts an Aboriginal government from US taxes on dividends paid by US stocks, but it also allows an Aboriginal government to diversify its investment portfolio by investing, tax-free, in a broader array of investments – including US real estate investment trusts and other US investment partnerships (such as private equity funds).

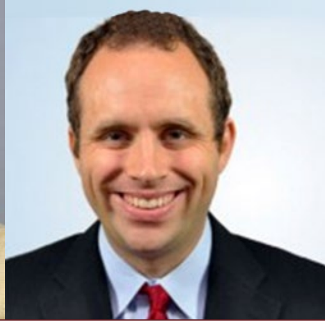
Eliminating the US withholding taxes will depend on how you structure your investment portfolio.

If you have invested in the US on a segregated basis, meaning you own the individual securities, then you simply have to determine your eligibility for the exemption and file the correct forms with the custodian. The custodian will then classify your account as exempt from withholding taxes, and you will be exempt from all future US taxes. This only needs to be done once to generate more income in future years. With a segregated portfolio, you can also easily claim a refund of past US withholding taxes paid. This is a nice extra cash infusion. If, however, you have invested in US securities through a pooled or mutual fund, the situation is more problematic. US taxes are withheld at the fund level, not at the individual investor level. Unless the pooled fund has registered with the IRS, it will not be able to exempt an Aboriginal government from US taxes. Claiming a refund of the taxes withheld by a pooled fund may be possible, but it will depend on the nature of the pooled fund and whether the investor can get the relevant information. Even if successful, refunds would have to be sought every three years, which is expensive and time consuming.

Some think that it is not worth the trouble. US withholding taxes are 15% of the dividends paid by U.S. stocks. With the dividends on the S&P 500 (the main U.S. equity index) at approximately 2%, that means the withholding tax is 15% of 2%, or 0.3% of the total US dividends paid. This money adds up when you have a large trust or investment portfolio and you are investing for many years.

A $20 million portfolio that has 15% invested in US equities with an average dividend yield would save approximately $9,000.00 in US withholding taxes. When converted to Canadian dollars at today's exchange rates, that is over $11,000. If the portfolio has a larger allocation to US securities, the dollar savings will be higher.

For a portfolio of $60 million with 15% in U.S. equities the amount would be approximately $33,000 Canadian each and every year. If the portfolio holds mostly higher paying dividend paying stocks, like Proctor and Gamble (which has a dividend yield of 3%) or Caterpillar Inc. (dividend yield 3.7%), the tax



savings could be much greater. Over the course of a decade for this portfolio, the additional income received could be well over $300,000. In one case we have successfully eliminated US withholding taxes of over $60,000 Canadian per year.

Of course, having the securities held on a segregated basis may incur additional custody fees. Based on our analysis of the reduced withholding taxes against the increased custody charges, we believe the breakeven point is in the range of $6-7 million. This assumes there is no Corporate Trustee already providing custody as part of their Trustee appointment. So if your portfolio is larger than this, the elimination of withholding taxes would result in increased revenue received each and every year. More money each year means being able to spend more on services to the community instead of paying the IRS.

Gaining additional income through the elimination of U.S. withholding taxes is a strategy that every Aboriginal government and their related trusts should be pursuing. Paying additional taxes that are not required is not in the best interests of the Aboriginal government or the members and trust beneficiaries. The authors have spent almost two years developing this strategy and have successfully implemented it with clients.

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