Foundation INsights

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Expanded Opportunities for Cross-Border Investments for Canadian Charitable Foundations

The relatively recent changes to the Canada-United States Income Tax Convention (the "**Treaty**") brought a favourable amendment to Article XXI of the Treaty which deals with "Exempt Organizations;" such organizations include charities. Many charities in Canada and the U.S. are still unaware of the amendment, although it has been effective for about two years, or fail to recognize that this change to the Treaty, which did not receive much public attention, in fact offers them greater cross-border investment opportunities, both outbound and inbound.

Generally speaking, charities that are resident and operating in Canada are exempt from Canadian tax by virtue of section 149 of the Income Tax Act (Canada) (the "**Act**"").
US charities may be subject to Canadian tax on active income earned from carrying on their activities in Canada or on passive income earned from Canadian debt or equity investments. Specifically, the withholding tax liability would be 25% of the gross amount of Canadian dividends or interest payments. There would equally be a withholding tax payable by Canadian charities for US sourced investments.

It is with respect to the withholding tax that the Treaty now provides relief both to Canadian charities earning passive income in the US

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and US charities earning such income in Canada. Before the 2010 Treaty amendment, income derived by a "religious, scientific, literary, educational or charitable organization" was exempt from Canadian or US tax, as applicable, if the organization was a resident of the other country. However, the treaty exemption was limited to the extent that such income was exempt in the organization's home country.

The 2010 Treaty amendment expanded the income tax exemption to include dividends and interest earned by an “Exempt Organization” in the other country provided that certain criteria are met: firstly, the “Exempt Organization” must be a resident of Canada, or the US, as applicable. Secondly, it must be generally exempt from income tax in its country of residence and, thirdly, it must be operated exclusively to administer or provide pension, retirement or employee benefits. This means that the current Treaty also exempts Canadian pension plans, for example.

More relevantly, a Canadian charitable foundation would can also benefit from the new Treaty exemption on dividend and interest income. Paragraph 3 of Article XXI exempts dividends and interest earned by an entity (trust, company, organization or other arrangement) that: (i) is a resident of the other country; (ii) is exempt from income taxation in that other country; and (iii) is operated exclusively to earn income for the benefit of, for example, a charity or generally what the Act would consider a "qualified donnee." This also means that a Canadian charity can now be an investor in a Canadian pooled fund that earns dividend and interest in the US without incurring a withholding tax liability in the US. The IRS had previously administratively taken the position that the class of permitted investors in a Canadian pooled fund that earned US sourced passive income did not include a Canadian charity. Administrative positions of the tax authorities are not law and are not even binding on the authorities themselves. However, they can create uncertainty with respect to the law. This uncertainty was eliminated through the Treaty amendment.

There are, however, some limitations placed on the interest and dividend withholding tax exemption: firstly, the income cannot be earned from carrying on a trade or business in the other country and it cannot be received from a related person that itself is not an "Exempt Organization" for purposes of the Treaty. Because the withholding obligation is placed on the payor of dividends or interest, the payor needs to be provided with evidence that the charity is treaty exempt before the payor will feel comfortable to make payment of the full amount of the dividend or interest owed. The most conclusive and reliable piece of evidence is a Letter of Exemption issued by the relevant competent authority (the Canada Revenue Agency ("**CRA**") or the Internal Revenue Service, as applicable). The applicant charity will need to provide evidence of its tax-exempt status in its country of residence. CRA generally issues Letters of Exemption under the Treaty for three-year periods. Because an application can take up to eight weeks to process, it is recommended that charities seeking the exemption or a renewal of the exemption should apply to CRA in a timely manner.

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