EMERGE CANADA INC.

TAX FACT SHEET

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Should a Canadian resident purchase shares of a Canadian or U.S.-domiciled Exchange Traded Fund (ETF)?

Canadian investors should buy the fund produced in Canada to achieve the most favorable tax consequences for income reporting and estate planning.

Are you a Canadian resident[1] who has the option to buy either a Canadian-domiciled ETF or a U.S.-domiciled ETF with the same underlying portfolio manager? Domiciled means where the funds originate, their country of origin.

With ARK Invest you have access to both families of ETFs as even U.S. listed ETFs can be purchased in Canada, even though U.S. non-registered sub-advisors can not promote funds in Canada. Emerge Canada created the Emerge ARK ETFs with ARK Invest as the sub-advisor in both a US$ version and CAD$ version to solve this problem and create a better Ark Invest opportunity for Canadian investors in Canada.

Emerge Canada **Emerge ARK ETFs** Canadian listed Both US$ and C$ versions available	**EARK** Emerge ARK Disruptive Innovation Best picks all themes	**EAGB** Emerge ARK Genomics & Biotech	**EAAI** Emerge ARK Artificial Intelligence	**EAUT** Emerge ARK Autonomous Technologies	**EAFT** Emerge ARK Fintech & Global Payments
ARK Invest **U.S. Listed ETFs** **U.S. domiciled**	ARKK ARK Invest Disruptive Innovation	ARKG ARK Invest Genomics	ARKW ARK Invest WEB	ARKQ ARK Invest Industrial Innovation	ARKF ARK Invest Fintech

There are several negative tax consequences when Canadian residents purchase U.S.-domiciled ETFs, and they should closely assess the implications.

Background information. Each year, mutual funds must qualify for tax status in their country of origin. These requirements are based on where the funds originate. U.S funds intend to qualify as a "regulated investment company" (RIC) under U.S. tax law[2]. To qualify the entity must be a U.S. domestic corporation. For Canadian tax purposes, any U.S.-domiciled ETF will therefore be treated as a non-resident corporation. For these reasons, here are some important facts for you to consider:

Tax Filing Requirements

[1] This Tax Fact Sheet assumes that the Canadian resident investor is not United States person. U.S. persons, regardless of their residence, who purchase units in Canadian based ETFs would be subject to the U.S. Passive Foreign Investment Company (PFIC) rules. It is recommended that U.S. persons seek U.S. professional tax advice before making such a purchase.

[2] IRC §851

1. **Filing Requirements.** Most Canadian residents know they must report their worldwide income, in Canadian dollars, each year on their Canadian tax return. Failure to file can bring significant penalties when there is a balance due. But when an investor owns foreign properties, there are more forms to file, described below. This can add to your professional tax filing fees.

2. **Reporting Specified Foreign Properties**. A share of this U.S.-based ETF would be considered, for Canadian tax purposes, to be a "specified foreign property" as it is "a share of the capital stock of a non-resident corporation". If the costs of the ETF shares and other "specified foreign property" exceeds C$100,000 at any time in the year, the taxpayer must file Form T1135 "*Foreign Income and Verification Statement*" with their annual Canadian tax return. There are significant penalties for non-compliance.

   The adjust cost base (ACB) for Canadian tax purposes will be the purchase price as computed in Canadian dollars (by converting the U.S. purchase price into Canadian dollars using an appropriate exchange rate such as the Bank of Canada daily spot rate). Shares of non-resident corporations are reported in section 2 of Form T1135.

Calculating After-Tax Investment Returns

3. **Foreign Dividends Received**. Canadian-domiciled ETFs distribute dividends that qualify for advantageous tax treatment. They are grossed up when reported as income, but then offset by a dividend tax credit.

   Distributions from a U.S. RIC (the ETF) to Canadian resident shareholders do not qualify for this treatment. They are usually taxed as foreign source dividends, 100% taxable in Canada[3]. These would be included in the Canadian resident's taxable income and will be taxed at the taxpayer's marginal tax rate.

4. **Capital Gains Dividends**. In the case of U.S. taxpayers, a portion of the distribution from a U.S.-domiciled ETF may be considered to be a long-term capital gain or a return of capital (ROC). This, unfortunately, is not so in Canada.

   A U.S. corporation cannot qualify as a "mutual fund corporation" under Canadian tax law[4]. Therefore, the full amount of the distribution, even if comprised solely of capital gains realized by the corporation, will be included in a Canadian shareholder's income as a fully taxable dividend[5].

   To be clear, the Canada Revenue Agency (CRA) has previously opined, that where a U.S. fund is treated as a corporation for Canadian tax purposes, *any distribution* by that corporation to its Canadian shareholders, on a pro-rata basis, would constitute a dividend for Canadian tax purposes.

5. **Return of Capital**. In Canada a return of capital is a tax efficient way to increase cash flow and/or reinvest. This results in a reduction in the ACB, and a deferred capital gain.

   In order for a distribution, from a non-resident corporation, to be considered a return on capital for Canadian tax purposes, thereby reducing the ACB[6], the distribution would have to be a return of capital under Canadian corporate law. The classification under U.S. tax law is irrelevant. Unless the distribution

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[3] ITA 90(1)
[4] ITA 131(8). Accordingly, the U.S. capital gain distribution received by a Canadian taxpayer cannot be elected by the corporation under subsection 131(1) of the *Act* to be a capital gains dividend to a Canadian shareholder.
[5] In accordance with ITA 90 and ITA 12(1)(k)
[6] ITA 53(2)(b)(ii)

so qualifies under Canadian corporate law, a "U.S." return of capital will be treated as a regular foreign source dividend for Canadian tax purposes, fully taxable.

6. **U.S. Forms and Compliance**. As a non-resident of the United States, in receipt of U.S. source income, the ETF will require you to complete and submit either a Form W-8BEN, W-8BEN-E, W-8ECI, W-8IMY or W-9[7]. The ETF will issue a Form 1042-S, "*Foreign Person's U.S. Source Income Subject to Withholding*" disclosing the amount of U.S. source income distributed, the character of the income, and the amount of any U.S. non resident tax withheld, if any[8].

7. **Potential Double Taxation**. As the income received from the U.S.-domiciled ETF is foreign source, Canada will allow a foreign tax credit (FTC) for any tax withholdings. This is to minimize double taxation on the same income. However, the maximum FTC that Canada will allow would be equal to 15% of the total distribution received[9]. Any U.S. tax paid, in excess of 15%, may be claimed as a deduction in computing taxable income[10].

   Sometimes the withholding tax can be 30%. If the correct amount of U.S. non- resident tax has been withheld (15%), there is no requirement for the Canadian recipient to file a U.S. non- resident income tax return (at least with respect to this income). If there is no W-8 form on file or the form is incomplete, the ETF would be required to withheld and remit U.S. non- resident withholding tax at a rate of 30%. A U.S. non- resident income tax return would have to be filed to claim the excess withholding back. This will lead to increased compliance costs[11].

8. **Estate tax impacts**. Under Canadian tax law, on the death of the investor, there is a deemed disposition of all capital assets at fair market value. The resulting taxable capital gains or losses, if any, are reported on the decedent's terminal tax return[12]. It does not matter whether the investor held a Canadian-domiciled ETF or a U.S.-domiciled ETF; they are both capital assets.

   Holding units in a U.S.-domiciled ETF, however, may subject the Canadian resident decedent to U.S. estate tax, as shares in the U.S.-domiciled ETF would be U.S. situs assets for U.S. estate tax purposes. Canadian resident investors, however, have access to the general U.S. exemption limits under provisions of the tax treaty[13].

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[7] The required form depends on your status in the United States. The purpose of the completed form is to assist the ETF in fulfilling its withholding and reporting requirements under U.S. tax law. The completed form is filed and kept on record with the ETF. It is not submitted to the U.S. Internal Revenue Service.

[8] For U.S. tax purposes, however, a portion of the distribution may be considered to be a long term capital gain or a return of capital (ROC). In general, these amounts are not subject to U.S. non resident withholding tax.

[9] Pursuant to Article X:2(b) of the Canada-United States Tax Convention (1980), the U.S. will impose a 15% non resident withholding tax on the gross amount of the "dividend" distributed to a Canadian resident.

[10] Under either ITA 20(11) or ITA 20(12) depending on the taxpayer's facts. The CRA may, however, disallow such a deduction on the basis that the U.S. over withheld its non resident withholding tax. If so, you would be required to submit a U.S. non resident income tax return and request a refund, of the excess withholding, from the IRS. This will add to the cost of professional fees. The alternative is double taxation on a portion of the investment income earned.

[11] The Canadian resident taxpayer would be required to obtain an IRS Individual Taxpayer Identification Number (ITIN) in order file the U.S. non resident income tax return.

[12] In general, property may also be transferred to a surviving spouse at the taxpayer's ACB. This defers the Canadian tax event on to the second to die.

[13] Article XXIX-B of the Canada-United States Tax Convention (1980). The U.S. estate tax rates and exemptions are very political in nature and have undergone significant changes since 2001. When purchasing shares in a U.S.-domiciled ETF, investors should seek U.S. tax advice.

Bottom Line:

The major issue with investing in a U.S.-domiciled ETF, vs. a Canada-domiciled ETF, is that the U.S. income does not benefit from any Canadian preferential tax treatment. The income is taxed as ordinary foreign source income, 100% fully taxable. This results in increased taxation, potential double taxation and an increase in overall compliance costs.

To manage tax risk and costs, therefore, it is more advantageous for Canadian residents to buy the Canadian-domiciled ETF. Here is a fictional synopsis (please consult with your advisors for calculations based on actual expected returns, and changes in tax rules, both federal and provincial, over time):

Illustration. The following table compares the one-year, after-tax value of a $100,000 investment in a Canadian-based ETF vs. a U.S.-based ETF. Assume the following:

(i) an 9% overall return on investment[14];
(ii) 3% of the distribution represents a dividend, 3% a capital gains distribution and 3% a return of capital;
(iii) the investor is a resident of Ontario[15],
(iv) the Canadian dollar and U.S. dollar are at par (in other words, for illustrative purposes, foreign exchange issues have not been considered[16] and
(v) the investment is sold at the end of one year for $110,000.

After Tax Returns on Investment		**Canada – Based ETF**	**U.S.-Based ETF**
Dividend Distribution - $3,000	**(A)**	$1,820	$1,394
Capital Gains Dividends - $3,000	**(B)**	$2,197	$1,394
Return of Capital - $3,000		$0[17]	$1,394
Capital gains/losses on disposition of investment		$13,000	$10,000
After tax gain / loss on disposition of investment	**(C)**	**$9,521**	**$7,324**
Total after tax income	**(A)+(B)+(C)**	**$13,538**	**$11,506**
How much total tax is paid by Canadian Resident?		**$5,462**	**$7,494**
After-tax return on investment (ROI)		**13.54%**	**11.51%**

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[14] The after-tax returns are meant to be illustrative only. As such, they may not be 100% accurate.
[15] For a resident of Ontario, ordinary income is taxed at a maximum rate of 53.53%, capital gains are taxed at a maximum rate of 26.76% and eligible dividends are taxed at a maximum rate of 39.34%.
[16] Foreign exchange has not been considered in order to highlight the tax differential only. In reality, purchasing the U.S.-based ETF will expose the investor to foreign exchange risks that would have a direct impact on the actual return on investment.
[17] The return of capital reduces the initial ACB by $3,000 to $97,000. If the investor were to reinvest the $3,000 into additional units of the Canada-based ETF, the total ACB will again be $100,000. Assume for this example, however, that the funds were not reinvested into the Canada-based ETF.