CRA: If You Make This TFSA Mistake, the IRS Will Tax You, Too!

Description

Do you want to enjoy the tax benefits that come with owning a TFSA?

If the answer to that question is yes, then you'll want to pay close attention to the account rules.

Not only can certain mistakes get you taxed by the CRA, but there are other subtle no-nos that can cost you as well.

Overcontributing is a classic TFSA error that get land you with a whopping 1% a month tax. Holding cash is another no-no, as it makes your "tax savings" negligible.

In this article, I'll explore another little-known TFSA mistake that can cost you big time. This is a subtle mistake that few people know about, but it can cost you huge amounts of money — particularly if you invest in dividend stocks. If you make this mistake, you could find yourself paying up to 15% a month on dividends, even in your "tax-free" account. And with this doozy, it's not the CRA that's the problem at all, but the IRS!

Holding investments that produce U.S.-originated income

If you hold U.S. investments that produce dividend income in your TFSA, expect to pay a tax. It doesn't matter how much you've contributed, how long you've held your account for, or whether you have more than one TFSA. If your TFSA contains U.S.-based, dividend-dealing stocks, the IRS will take a 15% cut.

Why the IRS gets to tax you

It all comes down to withholding tax. Generally, countries want to prevent capital outflows, and dividends paid by their companies fall under their tax jurisdiction even if the owner is foreign. This gives them the ability to tax foreigners on dividends, even though they're not under their income tax jurisdiction.

The U.S. is not alone in this. In fact, most countries charge foreign dividend withholding taxes of one form or another. But as a Canadian investor, you likely own more stocks based in the U.S. than anywhere else, so this particular withholding tax is one to watch out for.

What to do instead

Before getting into what you should do about foreign withholding taxes, one thing needs to be mentioned: an extra dividend tax isn't a reason *not* to own a stock.

Many stocks are good investments, even with 15% of the dividend shaved off — particularly if any capital gains are tax-free in your TFSA.

However, generally speaking, if you have the contribution room in both, it's best to keep your U.S.-based dividend stocks in your RRSP. Here, the foreign withholding tax is exempt, so you enjoy tax deferment on both dividends and capital gains.

As for what you *should* hold in your TFSA, that's more complicated. Ultimately, it comes down to your own investing style, especially how much risk you're willing to take on.

However, Canadian ETFs like the **iShares S&P/TSX 60 Index ETF** (TSX:XIU) can be great candidates.

As a Canadian ETF of Canadian stocks, XIU doesn't own anything subject to foreign withholding taxes. This means that it takes full advantage of the tax-exempt features of the TFSA. As a relatively high-yield ETF, it pays you sizable dividends that are completely tax-free inside a TFSA. Not only that, but the yield is higher than U.S. ETFs like VOO, so the starting amount of dividend income is preferable to that of IRS-taxed U.S. funds.

XIU and its sister fund XIC have long been favourites of Canadian investors, owing to their strong diversification and relatively high yields. These factors do indeed make them very desirable as investments. When you add in the fact that they're both totally tax-free inside a TFSA, it becomes a no-brainer.

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