TFSA Investors: A Top Tip to Avoid Getting Overtaxed by the Canada Revenue Agency

Description

It's tough to be a Canadian investor these days. The **TSX Index** has paled in comparison to the U.S. indices through the 2010s primarily due to Canada's overexposure to the materials and energy sectors, both of which have faltered. Diversification is the only free lunch in the investing world, so to construct a fully diversified portfolio, many investors have opted to head into the U.S. markets for what the domestic market has been unable to provide.

Despite the unfavourable exchange rate, many Canadians have scooped up U.S.-traded securities, with little thought as to what the implications are as a foreign investor.

As a Canadian who's invested in U.S. securities, one is subject to foreign income withholding taxes of 15% (it would have been 30% if not for a treaty). Uncle Sam takes his 15% share off your U.S. dividends before they're paid to your account. While a 15% cut may not seem like a lot, it makes a massive difference over a prolonged period of time, especially if you're invested in a U.S. stock with a large dividend yield.

Fortunately, you're able to apply a foreign dividend tax credit, so you're not hit with a one-two tax hit to the chin — a jab by Uncle Sam and an uppercut by the Canada Revenue Agency (CRA). If you hold a dividend heavyweight in your TFSA, though, you're unable to use such a credit and the 15% trim off the top of your U.S. dividends will be unrecoverable.

If you're going to pay taxes on dividends, you might as well keep your U.S. dividend heavyweights out of your TFSA because it won't necessarily be "tax-free" with foreign withholding taxes taken into consideration. Or, if you're feeling more patriotic (or deterred by that USD/CAD FX rate), you can look to a Canadian complement of the dividend-paying U.S. stock you may be holding within your TFSA.

Consider shares of **BCE** (TSX:BCE)(NYSE:BCE), a 5.1%-yielding telecom titan that mirrors many of the yield-heavy telecoms south of the border such as **AT&T**. Like AT&T, BCE is a bloated behemoth that's lacking in the growth department. Such stalwarts are still terrific sources of sustainable income, especially for retirees who depend on their dividends to finance their lifestyle.

As you may know, compounding is a powerful force. Tax-free compounding over the long term can make an unfathomable difference to the wealth-creation process.

Similarly with dividends, a seemingly modest 15% amount taken off your monthly or quarterly payment has the potential to add up. Thus, it's worthwhile to ensure your investments have a tax-efficient allocation, so you can keep your hard-earned money and not line the pockets of good, ol' Uncle Sam, who could rob you of substantial dividends over time.

AT&T currently sports a sizeable 5.5% yield, which is still bountiful at 4.68% after the 15% withholding tax is taken off the top. While the capital structure, strategies, markets of operation, capabilities of management, and all the sort vastly differ between BCE and AT&T, it would only make sense to hold the American AT&T as a Canadian if you're super keen on the name and see it as severely undervalued relative to the likes of its Canadian counterpart.

I just don't see that as the case at this juncture. AT&T currently trades at 19.8 times trailing earnings and BCE trades at 18.9 times. In essence, you'd be paying a premium to get less income after withholding taxes with AT&T for an arguably inferior company with a more bloated media segment.

When it comes to your TFSA, it can literally pay dividends (15% to be exact) to buy Canadian and take a raincheck on the U.S. dividend heavyweights.

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