



Your TFSA Isn't 100% Tax-Free If You Make This Mistake

Description

The Tax-Free Savings Account (TFSA) is supposed to be tax free, but TFSA investors beware, as it may be getting dinged from the taxman without your knowledge.

No, I'm not just talking about the Canada Revenue Agency (CRA), which could tax your TFSA if you break the rules of TFSA use, such as using the account for business trading activities. I'm also talking about the U.S. taxman, or Uncle Sam, as Americans know him, who's hungry for a 15% slice of taxes on your U.S. dividends and distributions.

Your TFSA is a powerful tool that can keep the CRA at bay if you play by the rules, but it can't stop Uncle Sam if you're getting paid dividends from [U.S. securities](#).

A simple solution is to just put your U.S. dividend-paying securities in your Registered Retirement Savings Plan (RRSP) or even a taxable account so you can claim a foreign tax credit. Your TFSA was meant to give you a [tax-free advantage](#), so if you're going to surrender a chunk in U.S. taxes, what's the point?

What if you're keen on holding U.S. dividend-paying stocks in your TFSA?

While it may be the wisest choice to move your U.S. and foreign income-paying securities into a non-TFSA account, many young investors like millennials may have zero desire even to open up or contribute to an RRSP, which unlike the TFSA, has some strings attached.

Furthermore, after over a decade since the TFSA's inception, many investors are seeing their TFSAs swell in size. And if you've got a TFSA north of the \$100,000 mark, it may not make sense to go all-in on Canadian securities just to avoid the foreign withholding taxes, while leaving sector and geographic diversification on the table.

Diversifying your TFSA

So, if you've got to use your TFSA to invest in U.S. or other foreign securities that will be subject to 15-30% foreign income withholding taxes, should you take the hit to the chin? Or is there another way to limit the damage from those pesky foreign dividend withholding taxes?

Consider the **Horizons S&P 500 Index ETF** ([TSX:HXS](#)), a synthetic swap-based S&P 500 total return ETF that makes use of financial derivatives to give Canadian investors a means to steer clear of U.S. dividends and distributions. No distributions mean you won't get dinged with U.S. dividend withholding taxes directly, but do mind the ~0.3% swap fee that you'll be on the hook for in addition to the 0.1% MER.

Tax-efficiency is the huge selling point of many swap-based ETFs.

For best results, it's best put in a taxable account and not a TFSA so one can defer their dividend tax liabilities until it's time to lock-in a capital gain, which is taxed more favourably in Canada.

However, there are attractive benefits of holding a total return ETF like the HXS in your TFSA versus a lower-cost vanilla ETF like the **Vanguard S&P 500 Index ETF** ([TSX:VFV](#)). Most notably with the HXS, you'll enjoy automatic reinvestment of constituent distributions, which can help one get the most out of compounding while saving one commission involved with reinvesting the real dividends that end up in your TFSA.

Although the 0% yield from total return ETFs like the HXS may be unattractive to income-oriented TFSA investors, it's a better option for beginner investors who aim to grow their TFSA wealth and find it inconvenient to have to wait for a certain amount of dividends to accumulate before being able to reinvest it to justify a hefty \$9.99 commission.

Foolish takeaway

The slightly higher price of admission into the HXS, I believe, is more than worthwhile, given the automatic reinvestment benefits in a TFSA or within a taxable account. You won't get dinged with U.S. dividend withholding taxes directly, but you will be on the hook for a swap fee.

With a taxable account, you'll be able to leverage the power of both the tax-efficient nature of the ETF and automatic reinvestment.

So, in short, the HXS is best used in a taxable account, but it's also not a bad option for the TFSA either, especially if your TFSA has grown in size over the years.

CATEGORY

1. Stocks for Beginners

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1. TSX:HXS (Horizons S&P 500 Index ETF)

2. TSX:VFV (Vanguard S&P 500 Index ETF)

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