TFSA Investors: Hold Off on U.S. Stocks. TSX Dividends Are Tax-Free

Description

The flexibility of the Tax-Free Savings Account (TFSA) is beyond compare, because users have so much leeway to make the most of their accounts. One salient feature is international diversification. It means you can hold U.S. and other foreign securities in your portfolio.

Some financial experts say it makes sense to set aside home country bias if the chosen foreign assets can deliver higher returns than their Canadian counterparts. However, not all would agree that this asset-allocation strategy is beneficial to TFSA investors. What's the point if there are tax consequences in a tax-advantaged account?

No tax exemption

Before the TFSA's introduction in 2009, the Income Tax Act lifted foreign content limits within a Registered Retirement Savings Plan (RRSP). The same rule applies to the TFSA. Thus, Canadians can hold U.S. stocks in either account. If the denomination is in foreign currency, the law mandates the total contribution amount must not exceed the annual limit in Canadian dollars

Remember, all interest, gains, or dividends you earn in a TFSA are 100% exempt from Canadian income taxes. However, dividend income from U.S. stocks is subject to a 15% withholding tax.

International diversification loses its appeal if the final yield on the investment reduces when the U.S. slaps you with the tax. Furthermore, there's no way you can recover such tax through a foreign tax credit or deduction when computing your taxable income.

Not included in the tax treaty

There's a material difference in the treatment of the TFSA and RRSP regarding eligible investments in U.S. stock exchanges. The Canada-U.S. tax treaty grants a U.S. tax exemption for investments held within an RRSP and Registered Retirement Income Fund (RRIF) only.

The TFSA is out of the loop, because it's not considered a pension plan, like the RRSP or RRIF. Note that interest income and capital gains earned on U.S. securities by any Canadian shall be taxable only in their home country under the said tax treaty. Therefore, if tax is your consideration, better hold off your plan to include U.S. stocks in your TFSA.

#1 source of tax-free dividends

Canadians need not cross the border to find a suitable anchor stock in their TFSAs. Most TFSA users have **Enbridge** (TSX:ENB)(NYSE:ENB) as their source of tax-free dividend income. The $80.57 billion, high-profile, energy infrastructure company is a standout for its reliable and growing dividends.

Even when oil prices were extremely volatile, the top-tier energy stock's dividend has grown at a compound annual growth rate of 8.85%. The current share price is less than $50 (only $39.86 per share), while the dividend yield is a high 6.78%. If you're a long-term investor, any investment amount will double in fewer than 11 years.

Enbridge's total return in the last 45.4 years is 44,335.81% (14.38% CAGR). This Dividend Aristocrat is a strong buy regardless of the market environment. In Q1 2021 (quarter ended March 31, 2021), Enbridge fully utilized its four blue-chip businesses. The results were strong operating performance and financial results.

The dividends should be safe given the highly contracted assets with investment-grade customers and resilient demand-pull franchises. Enbridge will likely do better, as global economic activity recovers.

Bottom line

Use your TFSA to the hilt and maximize the contribution limits every year if finances allow. Avoid paying taxes by concentrating on Canadian instead of U.S. assets.

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