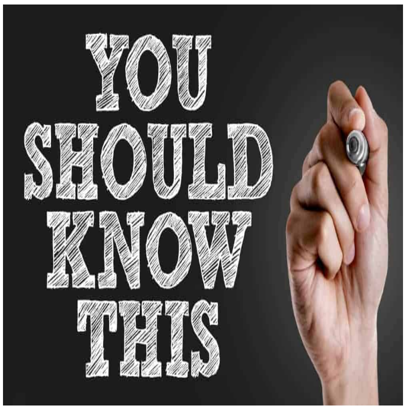

TFSA Users: You Could Pay 15% Tax on Dividends With 1 Costly Mistake

Description

All interest, gains, and dividends earned in a Tax-Free Savings Account (TFSA) are supposedly tax-free. Some users make mistakes that could merit attention by the Canada Revenue Agency (CRA). The common mistake of many is overcontribution.

Fortunately, you can quickly rectify the error. The solution is to withdraw the excess amount to avoid paying the 1% penalty tax on the overcontribution per month. However, a tricky setup could be costly. The CRA allows international diversification, but there's a catch. For this reason, TFSA users should hold only local assets in their accounts. Read on to know why.

Tax-free status

Generally, TFSAs are exempt from Canadian income taxes. Also, the Income Tax Act is more liberal, since it removed limits on foreign content in 2005. TFSA users, as well as Registered Retirement Savings Plan (RRSP) account holders, can hold unlimited foreign assets or stocks from abroad.

However, don't rush into using your TFSA contributions to purchase U.S. stocks, for example. While a tax treaty granting tax exemption for investment between Canada and the U.S. exists, the TFSA is out of the loop.

Different treatment

The U.S. treats the TFSA and RRSP differently when it comes to eligible investments on American stock exchanges. Only income earned by Canadian pension plans like the RRSP and Registered Retirement Income Fund (RRIF) enjoys the tax-free privilege.

Since the U.S. doesn't consider the TFSA a pension plan, a 15% tax applies to U.S. dividends paid to TFSA investors. Hence, the tax deduction at the source will reduce your potential earnings. Likewise, it's non-recoverable. Avoid this costly mistake by holding U.S stocks in an RRSP instead of a TFSA.

High-yield TFSA stock

The energy industry is booming lately due to rising crude prices and oil demand. **Exxon Mobil**, a US$263.03 billion American oil giant, is an attractive investment prospect for TFSA users because of its high 5.66%. However, the tax issue your stumbling block.

Homegrown **Keyera** (TSX:KEY) is equally appealing. The energy stock yields (5.55%) almost the same as Exxon, and you won't worry about taxes depleting income in your TFSA. Thus far, in 2020, Keyera outperforms with its 57.53% year-to-date gain.

The $7.65 billion company from Calgary operates assets in the oil and gas industry. You can find Keyera's core infrastructure in the Western Canada Sedimentary basin and Edmonton/Fort Saskatchewan energy hub. Both are key producing areas. All assets, including 14 active gas plants and over 4,000 kilometres of pipelines, are well maintained and have long economic life spans.

A significant takeaway is Keyera's long history of steady dividend growth. Over the last 10 years, management has raised dividends by 6% annually. In 2020, it paid around $423 million in dividends. The company generates profits year after year, although net income dropped dramatically in 2020 due to the oil slump and COVID-19.

Still, Keyera has excellent long-term business opportunities, as its capital programs focus on investments that support future growth. Apart from the fee-for-service cash flows, most agreements or contracts with oil producers are long term.

Undesirable

International diversification is ideal but not desirable in a TFSA. It would be best if you don't lose the account's tax-free status by holding foreign assets. As much as possible, keep Canadian assets to derive the maximum benefits of your TFSA. Any foreign assets should be in an RRSP for income tax purposes.

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1. Dividend Stocks
2. Energy Stocks
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1. TSX:KEY (Keyera Corp.)

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