TFSA “Gotchas” to Watch Out for This Year

Description

Hopefully, you have read the following before you end up paying hefty taxes for your Tax-Free Savings Account (TFSA). For more costly TFSA mistakes, check out my colleague Chris Liew’s article!

Don’t make TFSA contributions if you are living outside Canada

If you’re living outside Canada, then watch out! You don’t want to make TFSA contributions. If you do, they’ll be like overcontributions — the amount will be subject to a tax of 1% per month. If you’re a non-resident for an entire year, also note that you don’t get the TFSA contribution limit for that year.

Here’s an example. Jane is a Canadian resident and has $5,000 of available TFSA contribution room in 2020. She contributed $4,000 in January 2020. She ended up moving to the United States for a job offer in April 2020. In June of the same year, she contributed $2,000 to her TFSA. Jane expects to return to Canada in 2022. For this example, she doesn’t make any withdrawals.

Her $4,000 TFSA contribution made when she was a Canadian resident is fine. However, she must pay a tax of 1% per month for the $2,000 TFSA contribution from June 2020 to December 2021 because she was a non-resident during this period. That’s $380 of taxes she needs to pay (19% of $2,000).

While Jane was living in the U.S. for the entirety of 2021, her TFSA contribution room wouldn’t accumulate for that year. So, she would, unfortunately, miss the $6,000 2021 contribution limit. Since she would be back next year, she’ll benefit from the $6,000 TFSA contribution limit in 2022.

To make things worse for Jane, the U.S. doesn’t see the TFSA as a tax-free account. As a result, she will face additional tax consequences as a U.S. person in 2021 who needed to pay taxes to the U.S. for the TFSA income and capital gains in 2021.

Foreign income in the TFSA

Foreign income earned in TFSAs is subject to foreign withholding taxes. The tax percentage depends on which country the income is from. For example, U.S. dividends could be taxed 15% (30% in certain cases) in a TFSA. So, it's a much smarter move to hold big-yield U.S. stocks in your RRSP where there is no foreign withholding tax for qualified dividends.

Some Canadian investors argue that if their U.S. dividend stocks are growth-focused and pay yields of, say, 1% or lower, then they don't care about the typical 15% foreign withholding tax. 15% on a 1% yield equates to 0.15%, which is a puny amount from a total-return perspective. After all, most returns from growth stocks come from price appreciation.

Others counter that small yields can grow into big yields on cost down the road. For instance, if you'd bought **Visa** in 2009, your initial yield would be about 0.7%, and your yield on cost today would be north of 8%. That's a crazy dividend-growth rate (DGR) of approximately 35% per year in that period! Visa's three-year DGR of about 15% is still pretty incredible. If you invested $5,000 in Visa stock in 2009, you would be earning more than $400 in annual dividends from it by now. However, there's a 15% foreign withholding tax of over $60 for this year.

It turns out the +$60 and the previous smaller amounts of foreign withholding taxes you paid are mosquitoes compared to the cow of price appreciation (+$60K worth) you would have accumulated!

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Date
2025/07/26
Date Created
2021/12/03
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