CASE IN POINT

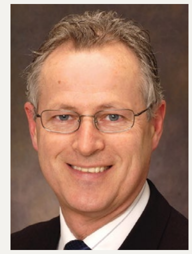
Sales Tax Estate Planning Underwriting & Product Newsletter

TFSA holding foreign investments

Your client, Ronald, is a Canadian resident and is not considered to be a US person for income tax purposes. He is reviewing his investment holdings and is considering topping up his Tax Free Savings Account (TFSA). He has heard and read about fund managers talking about the growth opportunities in holding foreign investments and how they can help with proper diversification. He wants to know if he can hold US investments inside a Tax Free Savings Account. What happens when tax free savings accounts hold foreign investments?

Ronald can hold foreign investments inside a Tax Free Savings Account. He can buy and hold foreign stocks in his TFSA as long as they are listed on a designated stock exchange. The designation is made by the Minister of Finance. There are currently 47 designated stock exchanges.

There is no Canadian income tax on dividends paid on that foreign investment. There are no distinctions between Canadian securities/stocks and U.S. stocks in a TFSA. That means any returns including dividends, interest or capital gains earned on U.S. stocks in a TFSA are not taxed by the Canada Revenue Agency (CRA). However, Ronald needs to watch out for withholding tax applied by the foreign jurisdiction, in this case the US.



Peter A. Wouters,
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Peter works with independent advisors and other professionals raising awareness on issues and concerns faced by affluent individuals, professionals and business owners. He supports efforts in researching and developing optimal solutions for clients aimed at improving their financial well-being and supporting their personal wishes and lifestyles. He has provided 1000s of workshops, seminars and technical support throughout the country on tax, retirement income and estate planning issues, concepts and strategies to both advisors and consumers. As an accredited Registered Financial Gerontologist, a good deal of his time is spent on building awareness and educating people of all professions who work with or specialize in the needs, expectations and issues of elders. Comprehensive lifestyle planning is an important element of these processes.

The Sales, Tax, Estate Planning, Underwriting & Product (STEPUP) team provides internal and broker support, including seminars, education, advanced concept illustrations & Client case technical consultations.

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The Internal Revenue Service (IRS) withholds 30% on dividends paid to a Tax Free Savings Account (TFSA). This can be reduced to 15% under the Canada-US tax treaty. Ronald will need to complete Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting) for individuals.

This withholding tax is problematic for Ronald since there is no foreign tax credit to use since no tax is paid in Canada on those dividends. Ronald will not see this withholding tax on his TFSA statements. The withholding tax is typically applied before an investor like Ronald receives his dividends as a credit to his TFSA account. In effect, Ronald's credited return on that investment is lower and now you and Ronald know why. Take that into account when choosing this type of investment.

When working with Ronald, consider the following options as planning points.

Ronald can still move ahead with investing in dividend paying US securities/stocks if he feels the return after withholding taxes is still better than investing in Canadian stocks. You and Ronald will need to go through the math and associated risk return analysis to determine if this is appropriate.

No withholding tax is applied on US dividends paid into a registered retirement savings plan (RRSP) or registered retirement income fund (RRIF) because the IRS recognizes these accounts as tax deferred retirement vehicles under the Canada-US tax treaty. Ronald can certainly hold dividend paying US investments in these vehicles.

The treaty does not cover Tax Free Savings Accounts and the IRS does not recognize these plans as tax deferred vehicles. What else can Ronald do?

Consider holding foreign dividend paying investments in non-registered accounts. Foreign tax credits may be triggered on income generated from foreign investments held in non-registered accounts. These tax credits can offset Canadian income tax on those investments.

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