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Investments

The TFSA: An excellent (but imperfect) account

The Tax-Free Savings Account (TFSA) is an excellent savings plan and one that several Canadians have taken advantage of since its introduction in 2009. But despite the plan's name, there can be some tax consequences for Canadians.

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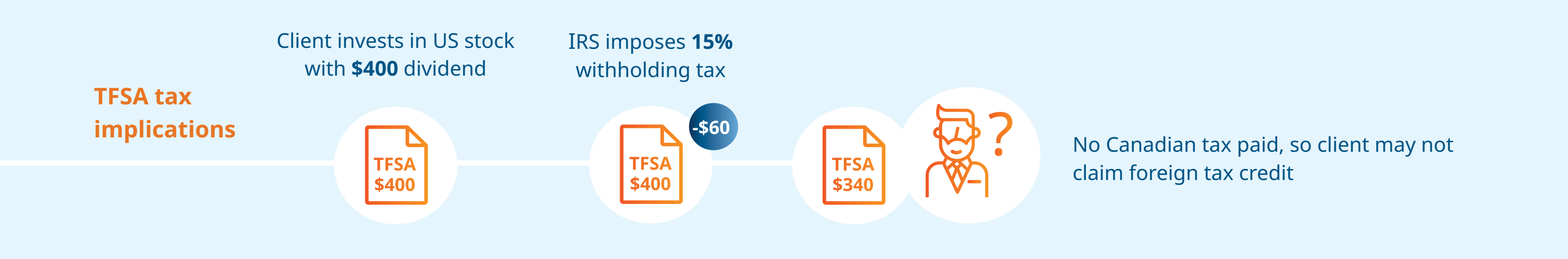
It's very important to be aware of the type of investments your client holds in their TFSA versus other account types. Particularly, there are issues that US persons need to be aware of when investing in a TFSA.

Generally, the US Internal Revenue Service (IRS) defines a US person as a US citizen, a US resident or a green card holder. Citizenship is generally obtained if the individual is born in the US, however transmission rules may apply to deem the individual a US citizen if they were not born in the US, but a parent, or both parents were US citizens. It may also apply to individuals who spend significant time in the US and meet the substantial presence test.

For Canadians

Let's first look at your Canadian (and non-US) clients and how they can be affected by their TFSA investments. Your client may hold foreign investments in a TFSA and, from a Canadian tax perspective, no tax would apply on dividends paid to the account. Yet when a foreign investment pays dividends to a TFSA, withholding tax applies. For instance, many taxpayers are unaware that the IRS generally applies a withholding tax of 15% (30% in some cases) on dividends paid to a TFSA.

For example, if your client invests in a stock that pays a $400 dividend with 15% withholding tax, $340 would be deposited to their TFSA. Since the TFSA is tax-free in Canada, the client is unable to recoup the withholding tax in the form of a foreign tax credit because no tax is paid in Canada. This means they essentially lose a portion of the dividend.



If, on the other hand, your client holds the US dividend paying stocks in a non-registered account, the withholding tax still applies, but since this account is taxable in Canada, they will have access to a foreign tax credit. As an aside, something to keep in mind with the non-registered account is that if the investment has a cost basis greater than $100,000 at any time in the year, the investor must complete Form T1135 – Foreign Income Verification Statement.

Another option is to have your client hold US dividend paying stocks in a registered account. When US dividends are paid to an RRSP or RRIF, withholding tax isn't applied because the IRS recognizes these as tax deferred retirement accounts under the Canada US tax treaty.

For US persons

Now, let's switch gears and look at issues that can arise for a US person. A TFSA is not considered tax-free in the US as it is in Canada, so the IRS requires information disclosures and US income taxes that need to be paid annually on the TFSA. The account is considered a foreign trust and the IRS requires that Form 3520 – Annual Return to Report Transactions With Foreign Trust and Receipts of Certain Foreign Gifts and Form 3520A – Annual Information Return of Foreign Trust With a US Owner be filed annually. It's likely that a tax preparer will charge an additional fee to file these forms. The RESP and RDSP are also considered foreign trusts, but the 3520 / 3520A reporting requirement was eliminated for those accounts in 2020. It's still required for a TFSA.

If the client has a financial interest or signing authority over $10,000 (USD), an FBAR (Report of Foreign Bank and Financial Accounts) report, also known as FinCen Form 114, must be completed, detailing all assets they hold, including the TFSA. Depending on the individual's net worth, other IRS information disclosures may be required.

Passive income generally includes

- **Rents**
- **Annuities**
- **Interest**
- **Dividends**
- **Royalties**
- **Capital gains**

If the TFSA is invested in a passive foreign investment corporation (PFIC), additional reporting will be required. A PFIC is a non-US corporation where 75% or more of the corporation's gross income is passive, non-business income and 50% or more of the corporation's assets produce, or are held to produce, passive income.

What about Canadian mutual funds and ETFs?

Canadian mutual funds and ETFs are considered PFICs and investors holding PFICs would generally be required to file IRS Form 8621 – Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund annually with their US tax return. To assist with the reporting requirement some Canadian investment firms provide annual information statements (AIS) to make PFIC reporting easier for US persons. These statements allow the investor to make an election for the qualified electing fund (QEF) and obtain preferential tax treatment. The benefit of this type of election is that high tax rates and interest charges can be avoided. This is because with the QEF election, income generated in the PFIC is generally taxed as ordinary income and capital gains are taxed as capital gains, which allows them to be more tax efficient. Another benefit to this method is that income and capital gains are taxed in the year they are received and not allocated to previous years. The QEF election is only available if the Canadian mutual fund provides the AIS. The fact that the investment income in the TFSA is taxable in the US but cannot be recouped in Canada as a foreign tax credit makes the TFSA less attractive for US persons living in Canada.

Summary

Even though the TFSA is an excellent account type, it is not a perfect fit for everyone. It's important that your clients are aware of issues that could arise whether they are invested in US dividend paying stocks or if they are a US person.

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