Foreign income tax tips and traps

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If you invest in foreign securities, such as US or global stocks and bonds, you need to ensure that you are properly reporting your income and any gains (or losses) on your Canadian income tax return using the appropriate exchange rates. Just as important, though, are the tax considerations of the type of account in which such foreign investments are held (e.g. non-registered account, RRSP, RRIF, or TFSA) and the effects on these investments when it comes to recovery or credit for foreign withholding taxes.

Foreign income, such as foreign dividends or interest, must be reported on your Canadian income tax return – in Canadian dollars. The Canada Revenue Agency (CRA) states that investors should use the Bank of Canada's exchange rate in effect "on the day you received the income."[1] If, however, the amount was essentially paid evenly throughout the year, then it's acceptable to use the average annual rate for that year, Exchange rates can be found on the Bank of Canada website.

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1 For example, see the CRA information for Line 12100 – Interest and other investment income.

The other cause of foreign currency tribulations is calculating the gains (or losses) properly on the sale of foreign stocks, bonds, or even real estate. For these transactions, you are supposed to use the actual foreign exchange rate that was in effect on the day of the transaction.

In other words, to report a gain (loss) on a foreign property properly, you would convert the proceeds to Canadian dollars using the exchange rate on the date of sale and compare that to the adjusted cost base or tax cost of the property using the foreign exchange rate on the date the property was purchased.

Keep in mind that the CRA requires you to report foreign-exchange gains (or losses) on your securities transactions even if the funds obtained from the sale aren't actually converted back to Canadian dollars, which may be the case if you are trading US stocks in a US dollar, non-registered trading account.

It's worth noting that any foreign taxes withheld on non-registered foreign income, such as US dividends, generally entitle you to claim a foreign tax credit when calculating federal and provincial or territorial taxes. The same foreign-exchange rates that were used to report the foreign income should be used to calculate the Canadian equivalent of the foreign taxes paid.

However, if you hold foreign income-paying investments in a registered plan – such as an RRSP, RRIF or TFSA – then you're not entitled to claim a foreign tax credit for the foreign taxes withheld. In addition, this foreign tax, which is generally at a rate of between 15% and 25%, becomes a drag on the investments' yield.

The good news is that there's an exception under the Canada-US treaty for US dividend-paying stocks whereby such dividends are not subject to withholding taxes when they're paid to a trust that provides retirement benefits, such as your RRSP or RRIF. This exception doesn't hold true for any other country, meaning that the withholding taxes paid on other global investments held in your RRSP/RRIF cannot be recovered. When it comes to TFSAs, though, they're not covered under the Canada-US treaty as they're not used exclusively to provide retirement benefits and, as a result, the aforementioned exemption doesn't apply. That's why both US and global dividend-paying stocks are best held outside of your TFSA so that they don't lose this non-recoverable, foreign withholding tax.

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