TFSA Investors: 2 Costly Mistakes You’ll Want to Avoid!

Description

A TFSA account can be a great way for investors to save for retirement. The big advantage is that on eligible investments, investors can benefit from both capital appreciation and dividend income and not be taxed on either.

However, there are some important limitations that investors need to be aware of, because treating a TFSA as a normal investing account could prove costly down the road.

Below, I’ll go over two potentially expensive mistakes that TFSA investors could make and how to avoid them.

Trading too often

If you’re an active investor, one of the dangers of using a TFSA is that if you trade too often, you could be in danger of any income being earned treated as business income and therefore not being protected from taxes, which is the main benefit of a TFSA in the first place.

The problem is that it’s ultimately up to the courts to decide if your trading activities are considered business income or not. There’s no fine line investors can rely on to say that because they’ve traded X amount of times that they’re not day traders.

If you’re successful at what you’re doing, and your TFSA has grown significantly (e.g., six figures or more), there’s a possibility it could attract the attention of the Canada Revenue Agency, and if that happens, your trading activity might come under more scrutiny.

There has been a case where even though a trader averaged a holding period of more than one month, their income was considered to be business income and taxable in the eyes of the courts. Since there is no firm definition of what a day trader is or when a TFSA ceases to shield your earnings from taxes, there’s a lot of grey area and lots of uncertainty that comes with it.

However, if you’re buying shares of a stock like **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) for the dividend income and you're likely going to hold the investment for years, then you've got nothing to worry about. A stock like TD is also unlikely to produce significant returns in a short amount of time, especially since it doesn't offer the volatility that a day trader would thrive on.

While you could earn double-digit returns when combining dividend income and the stock's overall returns for a given year, odds are you aren't going to be doubling or tripling your portfolio's value by holding shares of TD stock.

Let's say you buy TD stock just before it goes ex-dividend and then sell it afterwards, or if you only buy it before earnings and then sell if it spikes.

Those types of transactions might seem a bit more opportunistic, and if you did that for TD and other stocks, it could be seen more as business income rather than normal investing activity. However, here again, there's no definitive way to know for sure when that line has been crossed.

The other big downside of trading often is the commission fees that you'll also incur along the way, which could put a big dent in your overall returns.

Moving funds too often

One of the advantages of using a TFSA is that investors can withdraw their funds easily without having to worry about withholding taxes.

However, if investors take funds out of a TFSA, the important thing to remember is that the contribution room isn't freed back up until the start of the next calendar year. And so, unless you have room to contribute to your TFSA over and above what you withdrew during the year, you'll be hit with penalties if you try to re-contribute before the start of the next calendar year.

Bottom line

TFSAs are great tools for investors, but it's important to remember how to use them most effectively to ensure you don't get hit with fees, penalties, or that you don't lose the tax shield that the accounts can provide your portfolio with.

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