Canada Revenue Agency: How to Pay Zero Taxes on Your Passive Income Stream

Description

Your Tax-Free Savings Account (TFSA) is a tool that can help you build a substantial amount of wealth at an unfathomably quick rate through the power of tax-free compounding over decades.

The snowball effect can be diminished if you get fail to follow the TFSA's simple rule, though, even if you're unaware of them.

So, if you've overcontributed to your TFSA by a substantial amount or you've had too much success with short-term trades (you shouldn't be conducting "business trading" in your TFSA), then you can expect the Canada Revenue Agency (CRA) to come knocking for their share of the profit.

If you steer clear of the simple-to-understand "TFSA crimes," you won't have to worry about taxation, and you can construct a passive income stream for yourself that, unlike a CPP pension or employment income may not be touched by the taxman if you don't skate offside.

How much income your TFSA income stream yields is entirely up to you. There are no rules that stop you from going after the 12.5%-yielding REITs that pay monthly distributions.

And while you're free to withdraw from your TFSA, you should be aware of the recontribution rules and wait for the following year to avoid accidental overcontribution.

Even though you're not technically overcontributing since you're just putting back the amount you recently withdrew, you could still risk overcontribution through the eyes of the CRA, which has a year-over-year viewpoint.

You must gain an understanding of the rules of recontributing, as the seemingly trivial and innocent act of recontributing to one's TFSA promptly, may be one of the most common reasons for unknowingly overcontributing to in a given year, although I don't have the data to back up such a claim!

In any case, passive income investors ought to be careful not to risk overcontributing with recontributions as they take in the passive income as it comes in, either monthly or quarterly, especially for income investors who've already made their maximum annual contribution for a given year.

Consider a monthly income payer like **Shaw Communications**, a disruptive telecom that pays a growing monthly dividend.

Feel free to spend the tax-free dividends that Shaw gives you, but don't make the mistake of putting back any excess amounts that you don't intend to spend if you're up against the dollar limit in a given year.

If you're not at the upper end of your allowable contribution (you can easily check on the CRA portal), you may be allowed to recontribute without waiting until the next year.

Still, unless you're willing to keep track of your total contributions in a given year, I'd delay recontribution activities until the following year, just to be safe!

Foolish takeaway

Your TFSA passive income stream is only 100% tax-free if you play by the rules.

Many Canadians could be at risk of unknowingly overcontributing if cash flows in and out of their TFSAs frequently. While TFSA outflows are fine, frequent TFSA inflows may be a cause for concern and cause one to lose track of contributed amounts in a given year, subjecting them to penalties courtesy of the CRA.

The recontribution rules may not be logical for those who look at their finances from a week-to-week or month-to-month basis, but they're rules that must be followed to truly pay zero in taxes with your TFSA.

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