Should TFSA Millionaires Fear the Canada Revenue Agency?

Description

Getting to a million dollars in your TFSA can seem like a worthy goal.

Unfortunately, it can come at a heavy price.

If the Canada Revenue Agency decides that you're a trading business, they'll tax you as one, even if the trading was in a TFSA.

The rules on what constitutes a trading business are a little unclear. What's known is that an extraordinarily high TFSA balance can trigger an inquiry. From that point, if the CRA decides that you've been day trading, then your odds of getting assessed as a business increase.

If you had a lucky play in the markets and are now sitting on a high TFSA balance, that doesn't mean you're going to get a surprise tax. However, it would help to be cautious going forward. There are many examples of individuals who reached high TFSA balances using derivates and got taxed. One unlucky individual took the CRA to court over the matter three times and lost. These and other cases show just how seriously the CRA takes this matter. Fortunately, there are easy ways to protect yourself.

Avoid day trading

Simply having a few successful stock market plays doesn't mean you run a trading business. What could get the CRA to classify you as one is spending a good portion of your time trading. If you trade actively, use special software to inform your trades, or have access to special information, these are all good ways to pique the CRA's curiosity. Obviously, you don't want that to happen, so let's take a look at what you should do as an alternative.

How to prevent this happening to you

If you want to avoid getting taxed for running a trading business in your TFSA, it's a good idea to hold long-term dividend stocks like **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD).

Now, if you think you're a serious contender for a $1 million TFSA balance, you're probably laughing. Obviously, you want to get massively superior returns — you'll certainly need them to get a balance the CRA will look askance at. In light of this, why invest in a milquetoast bank stock that will get you 10% a year, if you're lucky?

First, let's get one thing out of the way:

Your odds of getting an extremely high TFSA balance in the first place are extremely low. Studies show that the vast majority of mutual fund managers fail to beat the market over the long term. If the professionals can't pull it off, you likely won't either. The same types of trades that could get you classed as a day trader if they work could lose you a pile of money if they don't.

Second, if you're one of the lucky few, then you have to contend with the potential taxes we just discussed.

So, buying and holding a stock like TD Bank serves two functions in a well-rounded TFSA:

1. Sparing you the risk of losing it all; and
2. Sparing you the risk of getting hit with a surprise tax on day-trading activities in the *best-case scenario*.

TD, as a Canadian bank with conservative lending practices, is the epitome of safety. It's no 10-bagger waiting to happen, but it should work out reasonably well over the long run. The company behind the stock has enough U.S. exposure to drive some growth, and, as a result, TD has out performed the TSX over the decades.

Thanks to its mix of conservative business practices, dividend income and U.S.-fueled growth, TD is a perfect TFSA holding. By buying and holding it, you're unlikely to lose your shirt OR get hit with any taxes that negate your TFSA's benefits. Sure, with a massive dose of luck, you could make way more money by day-trading derivatives. But if that puts you at risk of a massive tax in the best-case scenario, why chance it?

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