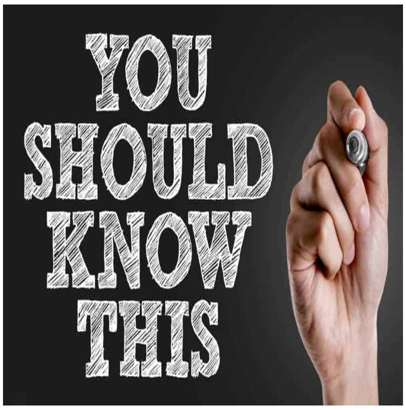

Worried That the Canada Revenue Agency Will Tax Your TFSA? Here's What You Can Do to Minimize Your Risk

Description

The Tax-Free Savings Account (TFSA) can be a great way to shield the income you earn from your investments from the tax man. However, being too reckless or aggressive with the account can cause problems with the Canada Revenue Agency (CRA). If you're too active in the account and the CRA considers you to be using the account more for trading than actual investing, you could be in danger of losing that tax shield. Another risk is that you overcontribute to your account, where you're hit with penalties as a result of doing so. While it seems relatively simple to keep track of your balance, you may be surprised as to how easy you could end up overcontributing without even knowing it.

These are just two of the instances where you could run into problems with the CRA, both of which could be costly.

How can you know if you're trading too often inside your TFSA?

When it comes to trading frequency, there is no prescribed limit that says you have to hold a stock for at least such and such a period to not be in danger of your TFSA earnings losing their tax shield. Even if you're not a day trader, you could still run into issues, as even holding an investment for one month has been seen by the courts to be very short. And because there is no definitive rule as to how long is long enough, the safest route is to simply avoid using a TFSA for any investments that you may be looking for a quick turnaround on.

A good way to prevent that problem is by using the TFSA for stocks that you plan to buy and hold, that you expect to keep in your portfolio for at least a year. The better the case you can make to prove that you're investing for the long term rather than looking for short-term opportunities, the better off you'll be in convincing the CRA of that as well.

There are, again, no guarantees here and ultimately if you end up with a successful TFSA that's grown significantly in value, it could ultimately be up to the courts to decide whether the funds are taxable or not. What you can do to minimize this risk is by keeping a log of what you're investing in and why you're doing so as well as the period you expect to hold shares for.

Overcontributing to a TFSA is a big mistake investors can make without even knowing it

It's also important to track the contributions you make to your TFSA to ensure that you aren't contributing too much. Since withdrawals aren't added back to your TFSA until the following year, investors need to keep a close eye on how much they've contributed in a year and how much has been taken out. Re-contributing a withdrawn amount too soon could mean you've overcontributed to your TFSA. The onus remains on you to ensure that you haven't gone over, as the CRA won't send out warnings that you're close to your limit, and, in some cases, people don't find out until months later that they've overcontributed, and by then they've incurred penalties.

A TFSA is a great vehicle to build your portfolio over the long term, but investors need to be careful when using it to ensure they don't jeopardize their tax-free income.

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