WARNING: Here's How the Canada Revenue Authority Can Tax Your TFSA

Description

TFSAs are simply incredible. They allow your capital to grow tax-free, but also give you the power of tax-free withdrawals. This is as close as it comes to free money.

But TFSAs aren't foolproof. Every year, thousands of Canadians make mistakes that eliminate their tax advantages. In most cases, simple awareness would have been enough to avoid any danger.

If you invest through a TFSA, congratulate yourself for making a wise investment decision, but don't forget some important rules that make sure this wisdom is protected.

Don't contribute too much

The easiest way to get your TFSA taxed is to over-contribute. Any money above the contribution limit will incur a 1% penalty every month until it's withdrawn. Ouch.

Fortunately, this is also one of the easiest mistakes to avoid.

The first step is to always know your contribution maximum. This year, it's $6,000, but because unused contribution rolls forward, your lifetime contribution could be much higher.

Your total contribution room starts to accumulate the year you turn 18. Any contribution room *before* that year is not eligible.

If you turned 18 in 2009, the year the TFSA was first introduced, your lifetime limit is simply the sum of each year's maximum: $69,500. If you turned 18 after 2009, simply add up each year's maximum.

From 2009 to 2012, the limit stood at $5,000, rising to $5,500 in 2013 and 2014. The annual limit jumped to $10,000 in 2015, falling to $5,500 between 2016 and 2018, only to rise again to $6,000 for both 2019 and 2020.

Never contribute more than your lifetime maximum. Still, there's one other way Canadian's get tripped up.

With a TFSA, you can withdraw funds at any time for any reason. This flexibility is one of the biggest reasons every Canadian should use a TFSA, but it's not without complications.

Any withdrawal opens up new contribution room for the following year. So if you withdraw $500 from your TFSA this year, you'll have an additional $500 in contribution next year. If the nation-wide limit is set at $6,000 in 2021, you'll personally have $6,500 in contribution room.

Note, however, that the new contribution room is for the *following* year. Thousands of Canadians regularly make the mistake of thinking it opens up new contribution room in the *current* year.

If you max out your TFSA contribution by July, and take a $500 withdrawal in August, contributing any more money for the current year will put you over the annual limit, incurring a 1% monthly tax. Simply wait until the following year to make up these contributions to avoid penalty.

Avoid day-trading

There is a lesser-known rule that catches many Canadians by surprise. As Fool contributor Adam Othman explains, TFSAs are only for long-term investments. The Canadian Revenue Agency will regularly track how often you trade to make sure you're not engaged in day-trading.

"If it notices that you are making several hundred trades every year, your revenue will be treated as enterprise revenue," Othman warns. "You will be taxed accordingly by the CRA."

Avoiding trouble is easy: stick with investments that can build wealth over decades, not days.

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Date
2025/08/26
Date Created
2020/01/10
Author
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