Canada Revenue Agency: This TFSA Mistake Could Land You With a $34,750 Tax Bill!

Description

Did you know that you could be taxed $34,750 or more in your “Tax-Free” Savings Account (TFSA)?

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It might sound unbelievable, but it’s true.

In 2020, the total TFSA contribution room you can have is $69,500, and there’s a tax mistake that can get you taxed at 50% — or $34,750. In fact, if you’ve seen capital gains in your TFSA, this tax could go even higher, because it’s based on the value of your investments rather than contribution amounts.

While this little-known tax rule is hard to break, it could be absolutely devastating if you do run afoul of it. In fact, it could totally negate all the benefits of having opened a TFSA in the first place. So, what is this little-known TFSA no-no?

Holding prohibited investments

Holding prohibited investments is probably the costliest TFSA mistake you can make. Over-contributing will put you on the hook for a 1% monthly tax, and day trading could get you paying income taxes in your TFSA. But neither of those can compare to the sheer destructive power of holding prohibited investments in your TFSA.

If you do that and get caught, expect to pony up 50% of your holdings’ value to the Canada Revenue Agency.

What is a prohibited investment?

According to the Canada Revenue Agency, three specific items are prohibited in TFSAs:

1. Your personal debts.
2. A company you own a 10% or more stake in.

3. A publicly traded company that you do not deal with at arm's length.

You might think that these would be difficult rules to run afoul of, but something as simple as putting shares in a private company into a TFSA could put you at risk. You don't want to get slapped with a 50% tax for doing something as silly as that. So, here's what to do instead.

Do this instead

If you want to be absolutely sure that your TFSA investments are non-prohibited, you should consider holding highly liquid index ETFs in the account. There are two reasons for this:

1. Most of them have huge market caps, so you're unlikely to own 10% or more of one.
2. These funds are operated by huge asset management companies, so unless you're a finance kingpin, you can be fairly certain you're more than an arm's length away.

Not only that, but low-fee index ETFs are generally some of the best investments around. Offering nearly guaranteed market average returns, they ensure both safety and reasonably solid gains.

Consider **iShares S&P/TSX 60 Index Fund** (TSX:XIU) for example.

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This is a low-fee index fund based on the TSX 60, the largest 60 stocks in Canada by market cap. By buying this fund, you get built-in diversification, which minimizes risk. You also get exposure to only large-cap stocks, so you avoid the risks inherent in some small-cap TSX equities.

To be sure, XIU won't become a 10-bagger overnight. However, it does have a historical tendency to outperform the TSX composite, which is the primary benchmark by which Canadian portfolios are measured. It also has a solid dividend yield of around 2.8%, which provides you with an income stream and a buffer against capital losses. It's simply a great way to get exposure to a diversified basket of Canadian stocks.

For a little extra diversification and some exposure to U.S. markets, you could also throw in the **Vanguard S&P 500 Index Fund** for good measure. It has even better historical returns than XIU and adds some geographic diversification to your portfolio.

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1. TSX:XIU (iShares S&P/TSX 60 Index ETF)

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