3 Ways the Canada Revenue Agency Can Tax Your TFSA

Description

The Tax-Free Savings Account (TFSA) is one of the most flexible registered accounts for Canadians. The program was introduced in 2009 and has fast gained popularity as a savings and investment vehicle for Canadians.

While any contributions towards the TFSA are not tax-deductible, any withdrawals in the form of capital gains, interests, or dividends are exempt from Canada Revenue Agency taxes. This makes the TFSA an ideal account to hold growth or dividend companies that can multiply your wealth over the long term.

However, the Canada Revenue Agency can tax your TFSA contributions if you don't meet certain requirements. Let's take a look at some of these scenarios.

Avoid TFSA overcontributions

While investing in your TFSA, you need to keep in mind the contribution limits for the account. For 2020, the TFSA contribution limit is $6,000 while the cumulative contribution limit is $69,000. There are other contribution rules that you need to be aware of.

For example, if you have contributed $6,000 towards the TFSA in 2020 and have withdrawn $8,000 from the account this year, you will have to wait until 2021 to make another contribution.

The Canada Revenue Agency levies a tax of 1% per month on the excess TFSA amount you have contributed.

The CRA taxes prohibited investments

If you buy investments prohibited by the CRA, you will attract a special tax equal to 50% of the fair market value for these investments. Further, in the case of prohibited investments, you might be liable for a 100% advantage tax on any income earned or capital gains.

The CRA taxes non-resident contributions

If you are a non-resident but contribute to the TFSA, the Canada Revenue Agency will levy a tax of 1% per month on these amounts. While the TFSA is extremely flexible and can be a vehicle that can help you achieve your long-term financial goals, you need to look at a few regulations before you invest in the account. Canadians need to ensure they do not overcontribute to the TFSA or invest in assets that are not qualified by the Canada Revenue Agency.

So, if you do not have the time or expertise to pick individual stocks for your TFSA, you can invest in ETFs such as **iShares Core S&P 500 Index ETF** (TSX:XSP). This index replicates the S&P 500 and provides you with exposure to the largest companies south of the border that include **Apple**, **Amazon**, **Alphabet**, **Microsoft,** and **Facebook**. The Index has returned 181% in the last 10 years, which means a $10,000 investment in XSP back in November 2010 would have been worth close to $28,000 today.

The XSP is a hedged ETF, which also protects you from currency fluctuations. Due to its massive diversification, investing in ETFs can lower your risk considerably. Further, the XSP has multiple growth companies and this ETF should easily outpace inflation rates over the long term.

In the last decade, the ETF has returned close to 11% annually. If we keep this growth rate as a constant and if you invest $500 each month for a period of 18 years, your portfolio value will be worth $3,28,000 at the end of the forecast period.

CATEGORY

1. Investing
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1. TSX:XSP (iShares Core S&P 500 Index ETF (CAD-Hedged))

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