Uh-Oh! The CRA Can Tax Your TFSA If You Do This 1 Thing Wrong

Description

A Tax-Free Savings Account (TFSA) is funded with your tax dollars, which means all the growth and passive income you get from it is yours to keep, and the CRA can't touch one dollar. That said, it's also important to remember that you are still bound by CRA's rules to use the TFSA.

The one rule that is of particular importance is the contribution limit. The CRA announced the TFSA contribution limit every year, and it has hovered around $6,000 since it's introduction. The CRA can't tax your TFSA funds that are within your contribution limit, but it *can* tax your TFSA if you over contributed.

Over-contribution taxation

Let's say you can only contribute $6,000 for the year to your TFSA. But you got a bonus or a surprise inheritance and decided to put $20,000 in your TFSA. The CRA will tax you 1% every month for the excess amount you have in your TFSA. In this case, the amount is $14,000, and you will pay $140 in the first month, 1% of the remaining amount on the second, then the third, and the CRA will keep taxing you until the next year.

When the next year starts, you will have more contribution room. If it's enough to absorb your excess amount, then your over-contribution tax will discontinue. But if it doesn't (the $14,000 excess will not be absorbed by the typical $6,000 contribution limit), you will keep paying the tax even if you don't contribute a single dollar to your TFSA next year.

The TFSA is not the "untouchable" of the registered accounts, and if you pick the right stock, you might not even need to over-contribute. You can achieve a lot with $6,000, the right stock, and enough time.

One potentially right stock

Clairvest (TSX:CVG) is a relatively underpriced growth stock that is currently trading at a price-to-earnings of 9.7 and a price-to-books of 1. The company also offers dividends, but a 0.99% yield might not be reason enough to buy this stock, even at this valuation, but the real upside to this stock is its consistent growth potential.

It offers a 10-year compound annual growth rate (CAGR) of 17.7% an a similar five-year CAGR. The stock also showed a steady recovery, and it's already near its pre-pandemic height.

Clarivest is a private equity management firm that invests its own and other investors' capital in different businesses. They take putting their own skin in the game quite seriously, and over one-fourth of the total capital currently under the company's management comes from the company's members. This shows clients that they are as invested in the preservation of the capital as their clients themselves are.

For their new round of investments (called Fund 6), they have only used about 11% of the available funds yet and bought five businesses. This means the company is sitting on a lot of liquidity to buy decent businesses in a market where there is currently no shortage of good but distressed businesses.

Foolish takeaway

Further, $6,000 growing at 17.7% will turn into $32,400 in a decade, and if the company managed to sustain the growth rate for two decades, just one year's TFSA contributions might grow up to $150,000. That's the power of the allowed contribution sum in the right stock, and should serve as an example that over-contributing to your TFSA is not just costly; it might also not be worth the cost.

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