TFSA Investors: Beware This Huge CRA Tax Bomb

Description

If you invest in a Tax-Free Saving Account (TFSA), you expect to pay no taxes on your investments. It's in the name, after all: *tax-free* savings account. As long as you hold approved investments and stay within your contribution limit, you should pay no taxes on TFSA stocks. And 99% of the time, it does work out that way. But there is one specific situation where you can find yourself getting taxed–*heavily* –inside a TFSA. This situation doesn't apply to most investors, however.

If you trade full time, you're at increased risk of having it happen to you. In this article, I'll explore the CRA's "TFSA tax bomb" and what you can do about it.

Trading professionally in a TFSA

If you trade professionally (i.e., full-time) in a TFSA, you could end up getting taxed *even if*:

- All of your investments are approved.
- Your contributions are within your limit.
- None of your investments are subject to foreign withholding taxes.

What "trading professionally" means is open to interpretation. But basically if you're earning a full-time income from trading, the CRA is likely to classify your trading activity as a business. While the standards used to determine whether your trading is a business are somewhat vague, some activities that have gotten people taxed include:

- Using special software to trade.
- Not having a full-time job.
- Earning enormous returns from trading.
- Using special, paid research services.

Neither one of these factors *alone* is enough to get the CRA to class you as a business, but enough of them in combination could.

Why it’s considered taxable even in a TFSA

The CRA classes professional trading inside a TFSA as a business because it contravenes the spirit of the account. In Canada, trading full-time is considered a business. The TFSA was not created to shelter such activities from taxation. Instead, it was designed to help working class Canadians save and invest. A person earning $1 million per year from complex derivative trades does not fit that description. Thus, the CRA is more likely to classify their activities by their nature rather than by the account in which they’re conducted.

Foolish takeaway

The bottom line is this:

It pays to invest in them, rather than trade in them.

If you hold a conservative portfolio of “buy and hold” stocks like **Fortis** (TSX:FTS)(NYSE:FTS) in a TFSA, you can realize enormous tax savings. On a $50,000 position in Fortis stock, you’d get about $1,835 in annual dividends. Inside a TFSA, none of that would be taxable. If you realized a $10,000 gain on Fortis shares in a TFSA, that would not be taxable either. So, investing in conservative Canadian stocks like Fortis in a TFSA is a wise idea.

But if you think you’re going to run a fancy derivatives trading operation in a TFSA and pay no taxes, think again. The CRA has the tools at its disposal to find trading businesses that are being run inside TFSAs. So stick to boring old “buy and hold” stocks like Fortis. In the long run, it pays off.

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2. TSX:FTS (Fortis Inc.)

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