TFSA Investors: How to Avoid Stealthy Taxation

Description

Tax-Free Savings Accounts (TFSAs) are amazing tools for investors. Allowing you to hold stocks and ETFs tax-free, they increase your total return. Taxes take a bite out of the actual, realized return you get from your investments. With TFSA holdings, taxes are $0, so they, in effect, have higher returns.

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So, TFSAs are great accounts for investors.

That doesn't mean they aren't without issues, though. If you aren't careful, you can actually end up getting taxed in a TFSA. There is even one tax you can be subjected to in a TFSA that's *higher* that the capital gains tax rate! Normally, the TFSA will save you money, but if you're not careful, it can cost you money. In this article, I will explore three "stealth taxes" you may incur in a TFSA and how to avoid them.

Overcontribution tax

The overcontribution tax is a tax you pay when you overcontribute to your TFSA. It's 1% per month on the portion of your contributions in excess of your limit. You may face this tax if you don't know what your TFSA limit is. Everyone gets the same limit every year, but the accumulated space depends on your age. To find your accumulated limit,

1. Find the TFSA amounts from year you turned 18 onward;
2. Sum these amounts; and
3. Subtract prior contributions.

The end amount is your remaining accumulated contribution space.

Unapproved investments tax

A second tax you can face in a TFSA is a tax on unapproved investments. You aren't allowed to hold stocks in companies you control in a TFSA. Doing so incurs regular capital gains and dividend taxes.

So, don't hold such stocks in your TFSA.

Instead, hold stocks you don't control, or even ETFs like **iShares S&P/TSX Capped Composite Index Fund** (TSX:XIC). XIC is an ultra-low cost ETF that invests in the Canadian stock market. Its management fee is only 0.06% per year. This is among the lowest fees you'll find in ETFs. As far as taxes go, it gets the same treatment as any individual stock. But since it's an index ETF, it gives you diversification benefits in addition to helping you avoid stealthy TFSA taxes.

Day trading "tax"

Last but not least, there is the day trading "tax." I put this one in scare quotes, because day trading isn't technically against the rules. But if you day trade full time and reap huge profits, the CRA may class your trading activities as a business. If that happens, then you will have to pay business taxes on your profits.

The tax rate is here your marginal tax rate, which is even higher than capital gains and dividend taxes! Obviously, you don't want to start trading in a TFSA only to find yourself getting taxed *even more* than you would on your income. So, it pays to keep any day trading to a minimum. Not only is day trading usually a losing strategy, but if you're one of the few who succeeds at it, you may find yourself getting taxed in your TFSA.

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