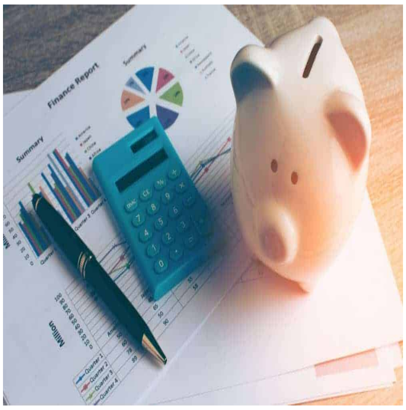

3 Things to Know Before Opening a TFSA

Description

Do you want to grow your savings tax-free without all the “gotchas” that come with an RRSP?

If so, a TFSA may be just what the doctor ordered.

Although RRSPs — Canada’s main tax-free account — come with a tonne of benefits, they can bite you in the behind if you find yourself having to withdraw early. TFSAs, while lacking tax deductions, give you tax exemption for as long as your holdings are in the account — AND upon withdrawal.

Because of their greater flexibility, TFSAs are more appropriate than RRSPs for short-term investing, or for investments you plan on using to pay for immediate expenses. However, there are some things you need to know before opening a TFSA — particularly if your plan is to save for retirement. We can start with the most important one: your investing goals.

Your investing goals

When it comes to investing, goals are everything. Whether you should take the safe road and buy blue-chip dividend stocks or “put it all on red” with high-beta small caps depends entirely on what you hope to achieve. If you’re saving for retirement, it’s generally best to take the safe and easy route — ideally inside an RRSP. If you’re investing mainly for a shot at becoming wealthy, the more volatile stocks may make sense, since their potential returns are higher. In this situation, a TFSA may make more sense than an RRSP, because if you do score that miracle tenbagger, you’ll be able to enjoy the profits in the here and now.

The annual TFSA contribution limit

One of the biggest drawbacks of TFSAs is their relatively small contribution limit. As of 2019, it’s $6,000, and while that figure could rise in the future, it’s currently much less than what a six-figure earner should be investing every year. Of course, this is no reason NOT to open a TFSA. In fact, you should almost certainly have some of your money in one. But from the outset, you should know that the amount you'll be able to put in is limited.

This could be something to keep in mind if you're investing in high-dividend stocks like **TransAlta Renewables** (TSX:RNW). TransAlta has a nice, juicy dividend yield of 6.7%, which might make it an appealing pick for those looking to live off payouts. However, with TFSA contributions maxing out at $6,000 annually, it would take you quite some time to build a position in TransAlta that you could live off tax-free for life. For this reason, if you're looking for high dividend income, it may be best to spread positions in stocks like TransAlta across several different accounts.

The penalty for contributing too much

A final point worth mentioning about TFSAs is that there is a penalty for contributing beyond the limit. If you go beyond the contribution limit, you get taxed at 1% per month, which can add up to quite a bit over the course of an entire year. So, if you're going to open a TFSA, definitely mind the ceiling — and stash some of your money elsewhere if you're going to be investing more than $6,000 per annum.

CATEGORY

1. Dividend Stocks
2. Energy Stocks
3. Investing

TICKERS GLOBAL

1. TSX:RNW (TransAlta Renewables)

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