



This Huge Mistake Could Shrink Your TFSA Contribution Limit

Description

The Tax-Free Savings Account (TFSA) is an exceptional tool for savers. The account acts as a tax shield that protects your dividend income and long-term capital gains up to a certain amount each year, shaving thousands of dollars off your tax burden over time.

As such, maxing out your annual TFSA contributions and investing wisely is the key to a satisfying retirement in this country. But the rules and regulations that govern this special account could work against you if you're not careful.

Here's a closer look at a common mistake that could actually dent the value of your TFSA permanently.

The magic of room expansion

The amount of money you can invest in a TFSA actually expands with capital appreciation. So, if you've invested \$50,000 into your account over time and the investments are now worth \$100,000 (congratulations!), you can sell your investments and withdraw the entire \$100,000 tax-free.

If you do so, your contribution limit for the next financial year would be \$100,000. In other words, your capital appreciation has temporarily expanded the room you have for tax-free capital deployments.

However, what if you *lose money* instead? If your \$50,000 TFSA turned into \$30,000 over time due to bad investments, liquidating your holdings will shrink your TFSA room when you withdraw cash.

Permanent capital losses in your TFSA could deliver a two-punch blow to your personal finances. Not only have you lost money on bad investments, but you've also adopted the opportunity costs of lower tax-free investment contributions. I would argue that over time, the opportunity costs of less contribution room matters more than present-day losses.

The solution?

While there's no way to predict the outcome of your investment decisions with precision, there's one simple way to avoid a severe hit on your TFSA contribution room: avoid speculative bets.

The TFSA could be used to buy steady [dividend income stocks](#) that deliver passive income or reasonably priced growth stocks that have a track record of expansion and the financial strength to fuel growth over time.

The key is to focus on seemingly boring companies with a track record of stable returns on equity and a conservative approach to cash management. It might also be better to focus on recession-proof, defensive industries like healthcare or waste management.

You should probably avoid penny stocks, risky biotechnology firms, [unprofitable cannabis stocks](#), crypto mining companies or volatile startups on the Toronto Venture Exchange for your TFSA.

Create a systematic investment plan that balances risk as well as reward over time. You can keep speculative and risky bets for your regular investment account. Losses in a traditional account can actually be claimed as a "capital loss" to reduce your tax burden.

Bottom line

TFSA investors tend to focus on maximizing their capital gains and passive income, while overlooking the risks of losing money in a tax-free account. Bad investments in a TFSA could permanently lower the room you have for contributions and the capital loss cannot be claimed as a write-off.

Instead, focus on stable income or reasonable growth stocks and keep speculative buys for your regular trading account. With clever tactics and a long-term strategy that balances risks and rewards, you can accumulate wealth efficiently and bring yourself one step closer to an early retirement.

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