3 Wealth-Destroying Mistakes to Avoid With Your TFSA

Description

Tax-Free Savings Accounts (TFSAs) are gaining greater recognition among Canadians as an ideal investment vehicle in which to create wealth and achieve their financial goals. While recognition of the benefits, notably their tax-sheltered status, continues to grow, many Canadians are making a few critical errors with their TFSAs, preventing them from fully benefiting from the TFSA's unique attributes. Let's take a closer look at three major errors that every account holder should avoid.

Overcontributing

Many Canadians treat their TFSAs as a transaction account, making frequent withdrawals and deposits. Many people lose count of how much they have contributed and exceed the annual limit, which is $6,000 for 2019 and totals $63,500, since TFSAs were introduced in 2009. When the contribution limit is exceeded, all excess amounts are taxed at a penalty rate of 1% per month.

Nonetheless, unlike an RRSP, when withdrawals are made from a TFSA the contribution room is not lost but becomes available from the start of the next calendar year. To remedy any overcontributions, an account holder can either withdraw the excess or wait for more room to become available the following calendar year.

Holding cash

Another serious error that is quite common is holding cash or other non-growth assets in a TFSA. According to a survey conducted by **Royal Bank of Canada**, 42% of account holders have a significant amount of cash in their TFSAs. This means they are failing to take full advantage of the account's tax-sheltered status.

All capital gains, interest, and dividends received in a TFSA are tax-free for the life of the investment. By reinvesting the dividends received, it is possible to access the magic of compounding and accelerate the pace at which wealth is accumulated, achieving your investment goals sooner.

Making speculative investments

Many Canadians, especially millennials, are making the mistake of using their TFSAs to hold speculative investments such as cannabis and tech stocks. While some companies in those industries, such as **Canopy Growth** and **Shopify**, which have gained 356% and 645%, respectively, over the last three years, have delivered outstanding returns for investors, they are not ideal TFSA investments. They are highly volatile and can expose investors to considerable losses, as highlighted by legal cannabis **CannTrust**, which has lost a whopping 87% over the last year.

In many cases, speculative stocks don't recover, and this not only impairs the creation of wealth but prevents TFSA investors from growing their contribution room. The amount that can be invested in a TFSA grows as the investment appreciates. If $10,000 is invested, and that amount appreciates to $50,000, the final balance can be withdrawn tax-free. Then, at the start of the following calendar year, $50,000, plus the contribution cap, which has been set at $6,000 for 2020, can be contributed to your TFSA.

However, if the investment declines in value, that increased contribution room is lost, creating a significant opportunity cost.

Those last two points highlight why it is crucial to hold high-quality dividend-paying growth stocks in a TFSA.

One top stock for every TFSA

The ideal stock is **Brookfield Infrastructure Partners** (TSX:BIP.UN)(NYSE:BIP), which, with a beta of 0.81, indicates that it is less volatile than many other stocks and the broader market. Brookfield Infrastructure owns a globally diversified portfolio of infrastructure, which is crucial to economic activity. A combination of steep barriers to entry, relatively inelastic demand for the utilization of its assets, and the contracted or regulated nature of Brookfield Infrastructure's earnings endow it with a wide economic moat. Those characteristics not only virtually guarantee earnings but protect the partnership from economic downturns.

By using Brookfield Infrastructure's distribution-reinvestment plan, unitholders can access the magic of compounding by using distributions to acquire additional units at no further cost. The advantage this provides becomes apparent when it is considered that over the last 10 years, Brookfield Infrastructure, where distributions have been reinvested, has delivered an annual return of almost 26% compared to 23% if they were taken as cash. This is a solid return, which substantially exceeds those produced by many other stocks and offered by cash investments, making Brookfield Infrastructure the ideal stock to create wealth in a TFSA.

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Date
2025/08/27
Date Created
2019/12/03
Author
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