TFSA Investors: 1 Fatal Mistake to Avoid During RRSP Season

Description

Are you a TFSA investor who also has an RRSP?

If so, it's worth being reminded of these accounts' dos and don'ts. As I've written in the past, it's easy to kill your returns by over-contributing, holding prohibited investments, or day trading in your registered accounts. These are all fairly well known and well publicized "no-nos." However, there's another big trap you can fall into that's not as well publicized — an account action that might seem logical but could actually hit you with a massive tax bill. Every year, many Canadians attempt to do this, and find themselves getting in trouble as a result. If you do make this mistake, you could get taxed by as much as 50% of your holdings' value.

So, what is this big mistake?

Transferring funds from your RRSP to your TFSA

Transferring funds from your RRSP to your TFSA might seem like a great idea. After all, we could all use a little extra TFSA cash, and RRSPs seem like a logical place to get it. However, this move has tax consequences that aren't worth it. If you transfer funds from your RRSP to your TFSA, you'll have to liquidate the shares and transfer the funds to a non-registered account first. The Canada Revenue Agency considers this an RRSP withdrawal, so you'll pay tax on it — potentially as high as 50% if that's your marginal tax rate.

Don't do this unless absolutely necessary

It goes without saying that you shouldn't transfer funds from an RRSP to a TFSA unless absolutely necessary. As previously mentioned, it's a withdrawal under Canadian tax law, and the taxes can seriously eat into your returns. There *is* a form (T2033) that allows you to transfer funds directly froman RRSP to other registered accounts without tax consequences, but TFSAs aren't covered by thatform. So, if you're a TFSA investor, it's imperative that you fund your account without taking savingsout of your RRSP.

What to do instead

Instead of transferring money to your TFSA from an RRSP, you can increase your TFSA cash balance by holding dividend-paying stocks in the account. By letting your dividends accumulate over time, you can see your TFSA cash balance grow — even if you have all your savings tied up in RRSPs. Then you can use the proceeds to buy more shares.

One great investment for this strategy is **iShares S&P/TSX Capped Composite Index Fund**. This is an ultra-diversified, low-fee ETF based on the TSX Index. The fund is about as low-risk as you can get with stocks, and it has one of the lowest MERs I've seen anywhere — a stunningly low 0.05%. That fee is low enough that you almost certainly won't notice it and more than worth paying to buy the market.

What's really worth mentioning about XIC in this context is its dividend yield. At 2.8% (trailing), it's among the highest you'll find in a true index ETF. There are dividend funds that have higher yields, but they're often actively managed, which may result in huge fees. XIC has a high enough yield to produce significant income even in a TFSA, so you can gradually build cash to buy other investments. You can also just reinvest your XIC units automatically to grow your position. Overall, it's a solid cash-building TFSA investment for any investor.

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andrewbutton