Avoid These 3 Big Mistakes in Your TFSA

Description

TFSAs, or Tax-Free Savings Accounts, are a wonderful tool that all investors should take advantage of. This type of account offers tax-sheltered growth and tax-free withdrawals.

Moreover, TFSAs are super flexible. First, in the account, you can pretty much invest any qualified investments, including cash, GICs, government and corporate bonds, stocks, mutual funds, and ETFs. Second, you can withdraw money from the account anytime tax-free.

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As a result, you can use your TFSA as a savings or investing tool to achieve all kinds of financial goals, such as saving for a mortgage, vacation, car…

However, here are some big mistakes you should avoid so that you can grow as much money as possible without hindrance.

Mistake 1: Over-contributing to your TFSA

One big TFSA mistake Canadians make is over-contributing to their accounts. The following example shows just how easy it is to over-contribute.

Let’s assume you only have $6,000 of TFSA contribution room in total. You contribute the full amount today. Then, three months later in July, you hit the jackpot! Your investments rise 20% and you decide to take out the full amount, $7,200, to help pay for a big purchase. By December, the market drops and you decide to put the $7,200 back into your account.

Big mistake! You’ve now contributed $13,200 in one year, which is $7,200 too much. You do get that to replace the $7,200 that you withdrew, but not until the following year.

You’d end up paying the Canada Revenue Agency 1% every month on the over-contributed amount. To stop the penalty, you’d need to withdraw the over-contribution. Or, you could keep on paying until January 1 for your new contribution room to appear, but I wouldn’t recommend it.

Avoid over-contributing by remembering the following formula that you can adapt for other years. (Just change the years accordingly.)

Your TFSA contribution room available when January 1, 2021, rolls around = Unused contribution room from previous years + Total TFSA withdrawals in 2020 + 2021's TFSA contribution limit (it was $6,000 in 2020).

Unused contribution room from previous years can include contribution limits (from previous years) and withdrawals that you haven't contributed back.

Mistake 2: Making risky investments

From the various types of qualified investments listed earlier, stocks are typically viewed as the highest risk. Yet, in the long run, they have generally delivered the greatest returns.

That said, new investors who are inexperienced in stocks may be shocked to learn that even our big Canadian banks, which are viewed as safe dividend stocks, can drop substantially.

For example, in the 2020 market crash, **CIBC** stock fell as much as 38% from its 2019 peak to its recent low. At writing, it offers a whopping yield of 7.2%.

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If investors take higher risks than they can bear, they may take losses in their TFSAs. That TFSA room is lost forever. So, ensure you're comfortable with the TFSA investments you make.

Mistake 3: Earning foreign income

Income from foreign countries may be subject to foreign withholding taxes, even in a TFSA. For example, if you earn U.S. dividend income in your TFSA, it is subject to 15% withholding taxes. You would end up getting an actual yield of 4.25% from a 5%-yielding U.S. stock.

Instead, you should use your RRSP for investing in qualified dividend U.S. stocks with juicy yields. That way, you can get the full dividend in the account.

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