1/3 of Canadians Are Clueless About This Crucial TFSA Rule

Description

One thing that many new investors have trouble understanding is the true cost of an investment. For them, the process is simple: buy low and sell high to gain a profit. And if you add dividends to the mix, that becomes the more consistent and dependable part of your investments, because the capital growth isn't as guaranteed as dividends are (usually).

A significant variable they seem to miss out on is taxes. If you include the taxes, you might need to pay for the gains you realize through investment, your profit margin might shift very drastically. This is why using registered accounts (RRSP and TFSA primarily) is so beneficial. Their tax-sheltered and tax-free nature means that you don't have to worry about taxes for a long time, or not at all.

This is where asset allocation comes into play. Understanding where to put your shares can have an enormous impact on your short-term and long-term investment goals and financial projections. And to make a smart decision, you have to know your registered accounts properly (i.e., their rules, limitations, and strengths, etc.). This is where one-third of the Canadians fail, especially when it comes to TFSA.

The TFSA rule that one-third of Canadians don't know about

The TFSA has surpassed the RRSP as the most used registered account, and still, one in three Canadians don't know about the most basic TFSA rule: the contribution limit. So many Canadians don't even know that there is a limit to how much money they can put in their TFSA, which may result in overcontribution. 33% Canadians *aren't* overcontributing to their TFSA, but they *can* because they don't know about the yearly contribution limit.

The yearly limit is straightforward. Each year, the government announces the contribution limit, whichis $6,000 for this year. If you haven't fully contributed to your TFSA in any given year, the remaininglimit is carried forward as well, until it's fully utilized. Similarly, if you withdraw an amount from yourTFSA (say for a down payment or a car), that amount will also be added to your TFSA contributionlimit, but for the next year.

TFSA and emergency reserves

While the RRSP is well suited for long-term investment and growth, and (ideally) withdrawing funds with you are in a lower tax bracket, the TFSA is excellent for emergency reserves. Even if you use just one-sixth of a year's contribution limit ($1,000) for building an emergency reserve, you may have access to substantial funds in about a decade or so.

For example, if you invest $1,000 each year for a decade in a safe stock like **Metro** (TSX:MRU), you may accumulate $25,000. That's considering that Metro follows the growth rate of 16% a year (dividend adjusted), which is its current 10-year CAGR. That might not seem like a lot of money, but it's just one-sixth of your yearly contribution to your TFSA. You can use the rest to pursue other investment goals, like rapid capital growth or establishing a dividend income.

The reason for building an emergency fund in your TFSA is that you'll have access to it whenever you need it, and you can take it out without incurring any financial penalty/taxes. Since the income is also tax-free, your tax bill for the year won't get to bear the burden as well.

Foolish takeaway

A contribution limit is one of the most straightforward TFSA rules to understand and follow. In the right stocks and assets, $6,000 a year can make a significant difference. There are other rules that you need to understand as well, like the fact that despite being an ideal place to save and invest for your short-term goals, the TFSA is aimed towards long-term investment and holding strategy and not day-trading. The latter can get your TFSA's tax-free status voided.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. TSX:MRU (Metro Inc.)

PARTNER-FEEDS

1. Business Insider
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