Want to Earn Passive Income With Dividends? Watch Out for These Traps

Description

If you're starting out with small amounts of money, it would be lower risk to invest in a dividend fund. Your investments would be immediately diversified, which is a safer way to invest than building a portfolio with one dividend stock at a time. Commission fees can add up, too, when you trade individual stocks. For example, if it costs you $10 per trade via your bank's online platform, the fee will be 2% if you invest $500 each time.

Trap #1: Tax implications

If you choose actively managed dividend mutual funds, you should be aware that your investment income could come from dividends, capital gains when fund managers sell stocks for profits, and capital gains when you sell units of the fund to book a profit. Holding the fund units, intending for long-term investing in a non-registered account, you might be surprised to have to pay income taxes on the dividends received as well as capital gains made by the manager for the year they're made.

If you choose to invest in dividend stocks, you'll need to pay income taxes on the dividends. Fortunately, dividend income is favourably taxed at a lower tax rate than ordinary income. This is why many retirees hold some solid dividend stocks for passive income. By holding individual stocks, you'll be in 100% control of when you take capital gains (if you choose to book profits at all). After all, you've got to hold the shares to earn passive income.

Trap #2: Not all dividend stocks are suitable for passive income

The **S&P/TSX Canadian Dividend Aristocrats Index**, which includes large, established Canadian companies that have increased their dividends for at least five consecutive years, is a good place to start researching for passive income.

Stocks that tend to increase their payouts try to continue doing so. Otherwise, investors will lose faith in their stock. A benefit for dividend stocks that maintain or increase their dividends over time is having a higher percentage of long-term shareholders that hold their shares for passive income, thereby, leading to a lower-volatility stock, which is often a trait that passive-income investors like.

Generally, if your sole purpose is to seek passive income, you would want to avoid dividend stocks that have highly volatile earnings or cash flows through economic cycles. For example, surely, it would be riskier to hold **Magna International** (TSX:MG)(NYSE:MGA) stock than **Fortis** (TSX:FTS)(NYSE:FTS) stock for passive income, as Magna's earnings are much more cyclical.

Magna's trailing-12-month (TTM) payout ratio was 76% of earnings, while Fortis's was 56%. As a regulated utility, Fortis's earnings are much more stable. That said, Magna does generate strong cash flow. Its TTM payout ratio of free cash flow was 58%. So, while Magna is a riskier investment, its dividend is not in danger presently.

Dividend stocks for passive income

Other than Fortis, you can also consider **Royal Bank of Canada** and **BCE** for passive income. Oh, and don't forget to explore Canadian real estate investment trusts (REITs) in your Tax-Free Savings Account to earn monthly cash distributions. Since REITs have a diversified portfolio of real estate assets from which they earn rental income, they're a good option to earn passive real estate income.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:FTS (Fortis Inc.)
2. NYSE:MGA (Magna International Inc.)
3. TSX:FTS (Fortis Inc.)
4. TSX:MG (Magna International Inc.)

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