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Canadians not exploiting the TFSA

Tax-free savings account (TFSA) rules are rather simple. Canadians 18 years or older can save up to $5,000 a year tax-free, with no maximum age limit on contributing, and unused contribution room can be carried forward indefinitely. Cash, stocks, bonds, GICs, and mutual funds are all eligible contributions. You can withdraw money at any time in any amount without being taxed, and re-contribute the full amount on a yearly basis.

But, according to a new poll by Royal Bank, three quarters (76%) of Canadians have not yet opened a TFSA. Lack of funds and not understanding them are given as the main reasons.

Despite significant benefits, many investors are not taking full advantage of tax-free savings accounts, sometimes simply using them as a place to park money. With current rates typically less than 1%, the real advantages of a TFSA are wasted.

That's a shame because, even though contributions are not tax deductible and capital losses cannot be claimed, TFSAs offer considerable potential for the investor.

Investors are better served using TFSAs to purchase high yield products or growth vehicles such as high yield corporate bonds or income trusts paying large distributions. Interest normally taxed at the individual's marginal tax rate would accrue tax-free.

Foreign company dividends in a non-registered portfolio are also treated as income and taxed at the individual's marginal tax rate. However, investors using a TFSA to hold their foreign dividend-paying stocks will gain the dividend income stream and any capital appreciation, free of Canadian taxation. The 15% withholding tax charged by U.S. tax authorities on U.S. investments held by foreigners still applies.

Quality companies with potential for growth are excellent TFSA candidates. For example, an investor who bought shares of Royal Bank at the start of the year now owns a stock paying a dividend of $2/share and has seen its price appreciate over 60% year-to-date. If that position was held inside a TFSA, this investor avoids capital gains tax on the eventual disposition of the stock as well as tax on the dividends.

You cannot claim capital losses for stocks depreciating inside a TFSA, and a stock that has lost money outside of a TFSA will be denied a tax loss if transferring directly into it. If you want to claim a capital loss, but also want the same stock inside your TFSA, you can do so in two steps.

You have to abide by the superficial loss rules, so you must first sell the stock and place the money in your TFSA. To crystallize your capital loss, you have to wait until 30 days after selling the stock before re-purchasing it inside your TFSA.

TFSAs have specific benefits for older investors. Unlike RRSPs, a withdrawal from a TFSA is not considered income and does not affect eligibility for Federal income-tested government benefits such as Old Age Security. Therefore, seniors can move their income-producing investments from non-registered accounts to a TFSA to prevent OAS clawbacks that might otherwise be caused by the income.

Another benefit for seniors is to reduce the sting of being forced at age 71 to annuitize RRSPs, or convert them to RRIFs, even when the income is actually not

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needed. Seniors cannot avoid taxation on those withdrawals but, by placing the excess in a TFSA, they can continue to earn income that is both tax-sheltered and exempt from OAS clawback rules.

Investors should explore all the benefits of TFSAs and choose the most appropriate for their circumstances.

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