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Canadians saving more, but are they making the most of their savings?

Profit from TFSAs by properly understanding them

Recent data indicate that Canadians are saving more. Statistics Canada reports that the Household Savings Rate is currently 5.4%, a 0.4% increase from the previous year. Likewise, a recent BMO Bank of Montreal study found that 48% of Canadians are now investing in Tax-Free Savings Accounts (TFSAs), a 23% increase from 2012.

It's good that Canadians are saving but unfortunately too few are making the most of it. Part of the problem is that many remain puzzled by the various investment vehicles available, and much of the confusion lays in TFSAs.

The BMO study found that only 11% of Canadians can identify eligible TFSA investments. And, only 19% understand the annual contribution limit; which might explain why one in ten TFSA holders has over-contributed since inception. Investors should spend a bit of time learning the rules so they can take full advantage of this very useful investment vehicle.

TFSAs are available to Canadian residents 18 years of age or older. They can save up to $5,500 per year in cash and investments, and unused contribution room can be carried forward indefinitely. Withdrawals can be made anytime in any amount, without being taxed, and can be fully re-contributed the following calendar year. It's important to remember that re-contributions in the same calendar year count against contribution room and could cause over-contributing, which the Canada Revenue Agency penalizes.

TFSAs can hold investments such as mutual funds, stocks, bonds, and GICs. However many investors don't realize this, perhaps confused by the words "Savings Account", and instead use their TFSAs to hold cash. BMO says cash is the most common component held in TFSAs, at 57%. Mutual funds weigh in at 25%, followed by Guaranteed Investment Certificates at 23%, stocks at 14%, and Exchange-Traded Funds at 5%.

The cash earns tax-free interest but the tax advantage is minimal in a low rate environment. TFSAs are best used for investments offering better growth potential. With income and capital gains accumulating tax-free, they are suitable for investments that otherwise generate greater total tax payable if held in a non-registered portfolio.

For instance, an investor who contributed $5,500 to a TFSA last year, with the full amount invested in an exchange-traded fund tracking the U.S., would be up by about 25%. The tax-free profit would be $1,375. Compare this to the investor who left the contribution in cash generating 1.50% and earning only $82.50.

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Although 25% profit is an exceptional year, the tax-free advantage holds true even at lower return levels. Consider an investor who puts $5,000 into a TFSA at the beginning of every year for the next 20 years, invested in a product generating a 6% gain per year. After 20 years, the TFSA would be worth $194,964. In comparison, if the investment was made in a non-registered account and taxed at a marginal rate of 32%, the balance would be $156,258. The $38,706 difference speaks for itself.

Since 2013 the TFSA contribution limits are $5,500 per year, up from $5,000 per year from 2009 through 2012. An investor who has never contributed to a TFSA, and has been eligible to do so since 2009, can invest up to $31,000 this year.

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