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Tax-Free Savings Accounts: A Sound Investment Option

Ben Franklin said: "The only things that are certain in life are death and taxes". Neither is pleasant to contemplate but with the latter you can at least find ways to avoid it, and the introduction of the Tax-Free Savings Account (TFSA) has made it a lot easier.

Effective January 1, 2009, Canadians 18 years or older can save up to $5,000 a year tax-free. Cash, stocks, bonds, GICs, and mutual funds are all eligible for the TFSA. There is no maximum age limit on contributing and any unused contribution room can be carried forward indefinitely. You can withdraw your money at any time and it will not be taxed.

In my opinion the TFSA is one of the most important advancements in personal savings since the introduction of the Registered Retirement Savings Plan (RRSP) in 1957. This is because it helps everyone. No matter what your financial status, you can benefit.

For instance, if you need to take money out of a TFSA, you can do so without penalties. This means that if you contributed $50,000 over the years to a TFSA and the investments held inside the account grew to $60,000, you can withdraw the full amount without having to pay any tax. If these investments were held anywhere else, the taxman would be knocking down your door.

TFSAs are particularly beneficial for lower income earners. Unlike an RRSP, a withdrawal from a TFSA is not considered income, which means that it will not affect any federal income-tested benefits or credits such as Old Age Security, Guaranteed Income Supplement, Canada Child Tax Benefit, Age credit, or the GST credit.

If you are still unsure of the benefits of TFSAs, the Government of Canada has provided some compelling figures. Consider a person contributing $200 a month to a TFSA. After 20 years, the account will be worth $48,000. With a 5.5% rate of return, the $48,000 investment will have grown to $87,525. If the investment were held in a non-registered account with an average tax rate on investment income of 21%, it would be worth $76,480 – a reduction of $11,045. Clearly, the TFSA beats the non-registered account hands down.

Even with these benefits, it is estimated that only 46% of Canadians plan to open TFSAs. While some people are simply not familiar enough with TFSAs, many have the misconception that RRSPs or TFSAs represent investments in the stock markets. This is not the case. If you're worried about investing in the markets you can use the TFSA to hold your cash savings, yielding significant benefits.

In a taxable high-interest savings account you might be earning 3%. Although this sounds reasonable, you need to take a closer look at the numbers. In a non-registered account, interest income is fully taxable. This means that your 3% figure is nearly cut in half at tax time. Worse yet, when inflation is factored into the equation, the number dwindles even more. In the end, your savings wind up no better or, in some cases, worse. In a TFSA, you could keep your cash in a high-interest product and retain your 3% yield.

No matter what your investing preferences, I strongly encourage you to open a TFSA. Although you can't contribute until January 2009, most investment firms and banks can get your TFSA set up early. Take a proactive approach to your future – open a TFSA today.

Kim Inglis is an Investment Advisor. The views in this column are solely those of the author. www.kiminglis.ca