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TFSAs ignored out of confusion

Investors should pay more attention to TFSAs

Tax-free savings accounts (TFSAs) may be the single most important change to Canada's tax code since RRSPs were launched in 1957 and yet they are largely ignored. According to an Investors Group survey, only 43% of eligible Canadians have opened a TFSA. Even worse, the majority of those are not making full use of them, pointing to confusion as the culprit.

However, the rules are simple. Canadian residents 18 years of age or older with a Social Insurance Number can open a TFSA and contribute up to $5,000 per year in cash or investments. Unused contribution room can be carried forward indefinitely and it never expires. Withdrawals can be made anytime in any amount, without being taxed, and can be fully re-contributed the following calendar year.

A common misconception is that TFSAs are simply savings accounts for extra cash. Too often, investors contribute their annual $5,000 and leave the cash to earn interest while using other accounts to invest in stocks, bonds, and mutual funds. Investors may earn tax-free interest on their cash but with low interest rates they aren't gaining much.

Investors should instead use TFSAs for investments offering better growth potential. Income and capital gains accumulate tax-free, so TFSAs are suitable for investments that cause tax headaches in non-registered accounts.

If an investor used a TFSA to supplement their stock portfolio, and bought 50 shares of Apple Inc. for $100 at the start of 2009, their $5,000 contribution would now be worth almost $18,000 tax-free.

If those Apple shares had been bought in a non-registered account, the result would be very different. Even with preferred tax treatment on capital gains, the $13,000 appreciation on the Apple shares would face a significant tax bite and the investor would have much less than $18,000.

TFSAs benefit all income levels. A young person can use a TFSA to delay contributing to an RRSP. At the start of their career, when income is at a lower tax rate, they can invest in a TFSA. After advancing to a better paying job, they can move funds from their TFSA into an RRSP, taking advantage of the RRSP tax deduction when their tax rate is higher.

High cashflow people can use TFSAs as an additional savings vehicle. Once they have maximized their RRSP, they can invest any extra funds in their TFSA to be another source of retirement income. Those unable to do both in one year can use their RRSP tax refund as a TFSA investment the following year.

Seniors and retirees, drawing more from their registered accounts than they require for living expenses, can reinvest the surplus in a TFSA

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Dividends pay real dividends

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where it will grow tax-free to provide additional income when needed. TFSA withdrawals are not considered income, so they do not trigger clawbacks of Old Age Security or the Guaranteed Income Supplement.

Families can take advantage of TFSAs. Attribution rules do not generally apply, so individuals can contribute to the TFSAs of other adult family members, effectively splitting income. These contributions can be made without affecting individual contribution limits.

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