BUSINESS VANCOUVER

DECEMBER 23, 2014

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Tax-free savings accounts still misunderstood

TFSAs around since 2009 but confusion remains

As one year passes and another unfolds, it's time to make Tax Free Savings Account (TFSA) contributions. They've been around since 2009 and yet Canadians still largely misunderstand them.

The annual BMO TFSA Report says 66 per cent claim to be knowledgeable about TFSAs, but only 22 percent correctly identified the contribution limit and 77 percent are unfamiliar with the over-contribution penalties. That would explain why one-in-ten have inadvertently over-contributed in the past, paying an average $412.50 in penalties.

TFSAs are available to Canadian residents 18 years of age or older, who can save up to $5,500 per year in cash and investments. 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. An investor who has never contributed to a TFSA, and has been eligible to do so since 2009, can invest up to $36,500 in 2015.

TFSAs are useful for all types of investors. They make sense for young people, beginning to save for retirement, who are still in lower income tax brackets and don't benefit much from the tax deductibility of RRSPs. It makes more sense to accumulate RRSP headroom until their marginal tax rate is higher.

Older investors also gain specific benefits. Unlike RRSPs, a withdrawal from a TFSA is not considered income and doesn't affect eligibility for Old Age Security. Seniors can move income-producing investments into TFSAs to prevent or reduce OAS clawbacks.

Families can take advantage of the fact that attribution rules do not generally apply, so individuals can contribute to the TFSAs of other adult family members, effectively splitting income. Such contributions don't affect individual contribution limits.

Investors in higher income tax brackets, who maximize RRSP contributions, can use the refunds to fund TFSA contributions. The invested refund can grow without fear of taxation either now or in retirement, essentially multiplying the positive impact of the original RRSP contribution.

The key to maximizing TFSAs is choosing the right investments. Data show TFSAs are still primarily made up of cash (60 per cent), followed by mutual funds (25 per cent) and GICs (20 per cent). Using TFSAs for cash & GICs is not making best use of them. The cash may earn tax-free interest, but that advantage in a low rate environment is minimal. TFSAs should be used for investments offering better growth potential.

Consider a scenario where one investor purchases an equity product while one leaves the TFSA in

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cash. An investor who contributed $5,500 to a TFSA last year, fully invested in an exchange-traded fund earning 10% for the year, would have a tax-free profit of $550. However, the investor who left the contribution in cash generating 1.50% only received $82.50. The difference speaks for itself.

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