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Tax Free Savings Account power increasing

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When Mark Seed opened his tax-free savings account in 2009, he figured he'd use it as a place to hold some short-term cash. And that's what he did at first.

Mark Seed in his Ottawa home.

Dave Chan/For the Toronto Star

He invested money for a year and then pulled it out to buy a house.

But when he wanted to put money back into his TFSA, he had a revelation.

"I started thinking, 'What was my long-term plan?' " says the Ottawa-based non-profit employee and author of the financial blog Myownadisor.ca

"I looked closer at the TFSA and realized it was actually an awesome retirement planning tool."

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As TFSA room grows, so does its power as a retirement savings vehicle. Although room only expands by $5,000 every year, if you haven't contributed yet, you'll have $20,000 of unused contribution room in 2012.

But the TFSA's role in retirement becomes even more valuable in years to come, as room continues to grow. Space starts to accumulate at age 18. If someone begins investing at, say, 30, they'll already have $60,000 at their disposal.

"The upcoming generation of investors will find themselves in a position here [in which] they don't pay any income tax on any investment income they earn," says Tina Di Vito, head of Bank of Montreal's retirement institute.

That's one of the things that has the 38-year-old Seed excited. He's loaded up his TFSA with dividend-paying stocks and every dollar that gets paid out goes to buying more equity.

"We're looking long-term as using the TFSA as an income fund," he explains. "We'll be able to transfer money out, hopefully 20 years from now, and use it for living expenses. And we'll be able to do it tax-free."

The biggest difference between the TFSA and the RRSP, today's main retirement savings tool, is tax. While Seed could hold yielding stocks in his RRSP, ultimately, when he withdraws, he'd have to pay tax on the dividends he received and reinvested. If he's in a high tax bracket, he could have to pay a significant amount.

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With a TFSA, he won't owe the government a cent.

Of course, he doesn't get a tax refund when he contributes to his TFSA, like he would with an RRSP, but that doesn't bother him. "I've basically got tax-free income compounding over time," he says.

Rona Birenbaum, a CFP with Caring for Clients, a Toronto-based financial firm, likes the TFSA for a number of reasons, but one is that investors only have to worry about the "pure" return.

If investors hold a stock that generates a 4 per cent yield and a bond that yields 4 per cent in a non-registered account, they'll end up paying tax on each. The dividend's after-tax return would be about 3 per cent, while the bond's after tax return would be closer to 2 per cent. (Interest is taxed at the person's marginal rate.)

In an RRSP, investors will have to pay tax on whatever they withdraw. The amount depends on their marginal rate in retirement.

With a TFSA, investors will get the full 4 per cent.

Another plus, says Birenbaum, is that money withdrawn from the TFSA doesn't affect government retirement benefits, such as the Guaranteed Income Supplement, Old Age Security and some medical benefits. If you claim a certain amount of income, those benefits can be reduced. Since you don't have to declare any income when withdrawing from a TFSA, the payments aren't affected.

"It's not as big of a deal for the high-income-earner, who will likely lose out on the benefits anyway, but for the middle-income zone, these things are very important in retirement," says Birnebaum. "So the TFSA becomes important."

The TFSA's biggest drawback is that room only rises by $5,000 every year. RRSP room increases are based on 18 per cent of your prior year's income. Make more than about $27,800 and your RRSP increase will be higher than the TFSA's annual raise.

On the other hand, for RRSP room to increase, you have to file a tax return, which means you have to earn at least some income. TFSA room jumps regardless of employment status.

Despite some drawbacks, it's hard to deny that the TFSA is becoming a stronger retirement tool every year. It has so much potential that Birenbaum is worried that the government could one day revoke the account's tax-free status or they may put a cap on contribution room.

With rising health care costs and slower economic growth, the TFSAs, “are not necessarily secure as a long-term plan,” she says. “They could say everyone has $100,000 of room and that’s it.”

Seed’s not thinking about whether the TFSA is here to stay. He’s focused on making as much money in his retirement portfolio as he can. The tax-free savings account, he says, is one of the most important parts of his retirement portfolio, second only to his pension plan.

“The TFSA is definitely going to be my retirement account,” he says. “I’d maximize it even if I didn’t have a pension.”

TFSAs come on strong

Three reasons why the TFSA could become our main retirement account:

• Growing contribution room. Canadians get their first $5,000 of room when they turn 18. If they don’t use it for years, they’ll have plenty of space to work with when they’re ready to save.

• It doesn’t affect government payments. Many Canadians rely on their GIS and OAS payments. If you take too much out of your RRSP those benefits can be reduced. Because TFSA income doesn’t have to be declared, it doesn’t affect those much-needed cheques.

• It’s not taxed. While you don’t get a tax refund for contributing, you also don’t have to worry about paying tax when you withdraw. A 4 per cent return is a 4 per cent return. With many people still working in retirement, their RRSP money could get taxed at a higher rate than they had initially planned for. That won’t happen with a TFSA.