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TFSA: Savings account or investment tool?

By Gail Johnson | Yahoo! Finance Canada – Fri, 24 May, 2013 3:26 PM EDT

When Laura Campbell first opened up a tax-free savings account (TFSA) two years ago, she assumed she'd use it just like any other savings account, making withdrawals when she needed a little extra cash.

But after talking to her a financial planner, the Vancouver-based web designer has rethought how she'll use that account.

Now, Campbell's TFSA is more an investment tool than a rainy-day fund.

"I used to treat it as a regular savings account, but now I'm using it for something with a higher interest rate," Campbell says. "I still make monthly contributions, but I won't be taking money out like I thought I would."

Canadian residents aged 18 and over can invest up to $5,000 a year in a TFSA. Investment earnings — such as interest, dividends and capital gains — are tax-free, as are withdrawals, unlike a registered retirement savings plan (RRSP).

Financial advisers agree that a TFSA can offer more to consumers than a place to park savings.

"The most beneficial way of looking at a TFSA is to consider it as being primarily an investment vehicle and not a conventional savings account from which to make short-term withdrawals," says Guylaine Dufresne, Laurentian Bank's director of financial planning for the Northwestern Québec region.

TFSA: What kind of investments work?

A TFSA can be invested in various ways, such as mutual funds, guaranteed investment certificates (GICs) and individual bonds and stocks.

Financial advisor Mark Neufeld is pictured in this undated handout photo.

"In my opinion, the single biggest reason TFSAs are becoming more popular is their flexibility," says Mark Neufeld, financial advisor with Rogers Group Financial. "Plus, the contribution room for a TFSA is cumulative, and the full amount of any withdrawal from a TFSA can be put back into a TFSA in future years."

Other factors distinguish TFSAs from conventional savings accounts, notes Phil Tippetts-Aylmer, Nicola Wealth Management financial advisor. "With TFSAs, there are rules regarding the maximum contribution levels each year, which can have fairly severe penalties applied if they are broken," he says.

"Perhaps people's lack of awareness of how these accounts work has led to the unintentional misuse of them and has in turn resulted in penalties being incurred by those who didn't fully understand how they worked, an issue I'd expect to see diminish over time as people become accustomed to the TFSA rules."

Exactly what type of investment vehicle works best for an individual with a TFSA depends on your circumstances.

"In some cases, a very low-risk investment such as a GIC or high-interest savings account is appropriate," Neufeld says. "This may be an appropriate strategy for someone who feels they may need access to the funds in the TFSA in the short-term, for instance for travel or for home improvements.

"In other cases, a higher-risk investment, such as an individual stock or equity-based mutual fund, is appropriate — say for someone who anticipates they have no need to access the funds in the TFSA for many years."

Ian Black is pictured in this undated handout photo.

Ian Black, fee-only financial advisor with Macdonald Shymko & Company Ltd, cautions that investors need to be aware that there's no opportunity to write off capital losses incurred within a TFSA.

A capital loss is incurred when an investment, such as stocks or real estate, is sold at a loss. A capital loss can usually be used to decrease the amount of tax paid on a capital gain, which is incurred when an asset is sold for a higher price than what was originally paid for it.

"Some people view these as a way to use a risky asset, hoping it's going to have a large capital gain, because it's tax-free," he says. "But if it ends up going bankrupt or having a loss, you can't use that as a capital loss."

TFSAs aren't necessarily for everyone, Black adds. "If someone has non-deductible debt, like mortgage debt, it may not make sense to put money into TFSA as opposed to paying interest on the mortgage."

TFSA advantages

However, TFSAs have other advantages aside from their use as an investment tool.

"You're not forced to roll it to a RRIF [Registered Retirement Income Fund] at age 71, unlike an RRSP," Black says. "A TFSA can be used as collateral for a loan — you may be able to get a bit better rate — while an RRSP cannot," he adds, noting that if you collapse an RRSP to pay off a loan, it counts as income.

For people with both TFSAs and RRSPs, deciding when to contribute to each depends on the individual, says DWM Securities Inc. certified financial planner Bettina Schnarr.

"There isn't one method that fits all," Schnarr says. "One thing to consider is what tax bracket you're in. It usually makes sense to maximize your RRSP contributions first before moving on to the TFSA if you're in a higher tax bracket.

"Would you consider taking money out of your RRSP before retirement? If yes, then set up a TFSA in addition to your RRSP," she adds. "I've seen too many people withdraw from their RRSPs to pay off a credit-card bill or what have you and end up paying redemption fees as well as taxes. I prefer my clients have both TFSAs and RRSPs."