TURNER INVESTMENTS COMMENTARY

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IT'S FUN TO STAY AT THE T-F-S-A

Last month, with the help of our financial planner Sebastien Skupek, we discussed the merits of RRSPs and how to effectively employ RRSPs for maximum tax advantage. We briefly touched on TFSAs and why, all things being equal, they are our preferred account type. This month, we'll take a closer look at TFSAs and elaborate on our pro-TFSA argument.

THE BASICS

While this may be routine for many, let's go over the basic TFSA rules. Most types of investments can be held in a TFSA: cash, GICs, mutual funds, bonds and stocks, for example. ETFs can also be held in TFSAs because they trade on a stock exchange. This is important for our clients because we invest only in low-cost ETFs. You must be 18 years or older to open a TFSA and have a social insurance number. Non-resident Canadians can have TFSAs but there are penalties for further contributions and you may lose contribution room during years you are a non-resident. Basically, if you become a non-resident you can have a TFSA, but in many respects it becomes a 'frozen' account.

As we highlighted last month, the adjacent chart shows contribution limits by year. Unlike an RRSP, there is no contribution deadline. This is an advantage but can, unfortunately, create poor discipline with respect to making consistent contributions. In order to keep you on track, we always send out a reminder email at the start of each year (once the government has announced the contribution limits) and encourage our clients to keep their TFSAs topped-up during our regular portfolio reviews. You also carry forward unused contribution room indefinitely, so it is never lost if there is a year you fail to contribute. Foreign funds can be contributed to a TFSA, but they are converted to Canadian dollars for calculating contribution amounts.

TFSA Contribution Limits

Years	TFSA Annual Limit ($)	Cumulative Total ($)
2009–2012	5,000	20,000
2013	5,500	25,500
2014	5,500	31,000
2015	10,000	41,000
2016	5,500	46,500

Source: CRA

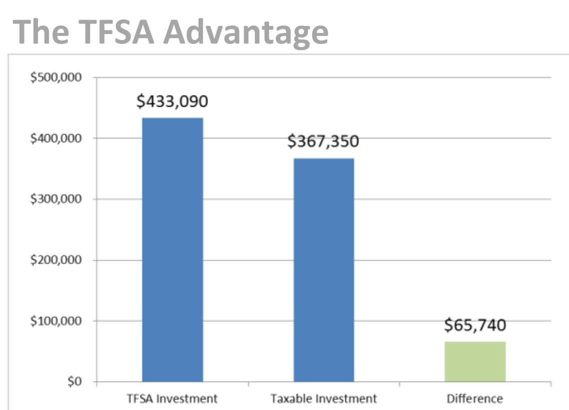
TAX IMPLICATIONS

Contributions made to a TFSA are not tax-deductible. This is the TFSA's main disadvantage compared with an RRSP. So don't pile a chunk of money into a TFSA expecting a big cheque from the government at tax-return time. However, unlike an RRSP, there are no tax consequences for withdrawals, which include the capital gains made within the TFSA. For example, if you place $5,000 into a TFSA at the start of the year, earn 5% and then withdraw $5,250 at year-end, there are no tax consequences—in other words, no T4 slip from the government. Unfortunately, you can't utilize capital losses within a TFSA to reduce tax liabilities, but as we've highlighted in many previous newsletters, markets have a reliable tendency to move higher over time, so the inability to utilize capital losses should have limited impact on low-turnover, long-term TFSA investors. In other words, all things being equal over the long term, capital gains will be the more likely outcome from transactions within a TFSA.

Contributions to a TFSA don't always have to be made in cash. Contributions can also be made 'in kind' by moving securities over from non-registered accounts. However, there may be tax consequences resulting in such transfers. Once a security is moved over to a TFSA it is considered a deemed disposition. Effectively, the security is considered sold at current market value and any applicable capital gains must be reported on your income tax return. However, keep in mind that capital gains taxes are favourable and they mean you made a profit—never a bad thing. It's also a short-term tax hit in exchange for the long-term benefit of having that security's future capital gains incur no penalty whatsoever.

TFSA INVESTMENT STRATEGIES

Because taxes don't apply to capital gains within a TFSA, we recommend positioning TFSAs towards growth, which therefore implies a strong bias towards equities. The advantage of having capital gains accrue tax-free is highlighted in the adjacent chart. The majority of our clients have TFSAs typically weighted at least 70% to equities, sometimes as high as 100%. Many of our client TFSAs will also hold preferred shares as we believe that, in addition to their attractive yields, they have capital-gain potential (indeed, they've rallied strongly since their January lows), but it should be noted that dividends paid within a TFSA don't receive the government's dividend tax credit.



Source: Ativa. Chart assumes starting value of $46,500 and $5,500 contributed each year at a 5% annual rate of return over 25 years. Return on the taxable investment consists of 33.3% interest, 33.3% eligible dividends and 33.3% capital gains. Calculations are based on the Ontario tax rate.

While TFSAs should be positioned for growth, investors shouldn't take *excessive* risk. As we highlighted above, there is no tax benefit for a capital loss, so very volatile investments more likely to incur downside risk often aren't advantageous within a TFSA. Broad equity market exposure via ETFs, which are likely to experience only temporary losses, are appropriate within a TFSA, but individual high-risk stocks or bonds that may experience prolonged or even permanent losses are not appropriate. There is no silver-lining for a major loss within a TFSA.

Because TFSAs are still relatively small in terms of asset size, many financial advisors simply position TFSAs as short-term investment tools. In other words, these accounts are utilized to make a quick (but risky), tax-free buck perhaps for a big-ticket purchase such as a trip, boat or RV. However, we believe that TFSA contribution room will only continue to expand (see 'Future of the TFSA' below) and therefore TFSAs will become a more and more meaningful retirement-planning tool. For most investors, TFSAs are not yet quite of a size to meaningfully impact retirement plans—the lifetime contribution room currently sits at only $46,500—but every year TFSAs become more useful for retirement savings, particularly if your retirement date lies a decade or more into the future. Based on the way we've structured our client TFSAs—high equity weightings—they will naturally be more volatile than other account types, particularly RRSPs, which we generally bias more towards fixed income for tax-efficiency purposes. However, we believe TFSAs should no longer be used for specific, short-term goals, but rather as long-term retirement planning vehicles and therefore the short-term volatility becomes less meaningful.

OVER-CONTRIBUTIONS

There is a 1% per month penalty for over-contributing to a TFSA (applied to the over-contributed amount). Therefore it is important to know exactly your contribution room. Unfortunately, we don't have your full contribution history. This information is only available through the Canada Revenue Agency (CRA). Often our clients want to 'wing it' and give us an unverified TFSA contribution amount. We strongly discourage this. Sometimes going over your contribution limit can be the result of a simple oversight. For instance, many banks when opening chequing or savings accounts insist that clients also open a TFSA and place a token amount such as $100 into it. We have no record of these small contributions and you could easily forget that such a contribution was made. The best way to be entirely sure of your available contribution room is to directly contact the CRA. Trust us, it's far easier to check this simple bit of information with the CRA ahead of time rather than having to explain yourself through countless emails and phone calls after you've over-contributed. You can contact the CRA via http://www.cra-arc.gc.ca/myaccount/ or you can also call them directly at 1-800-959-8281.

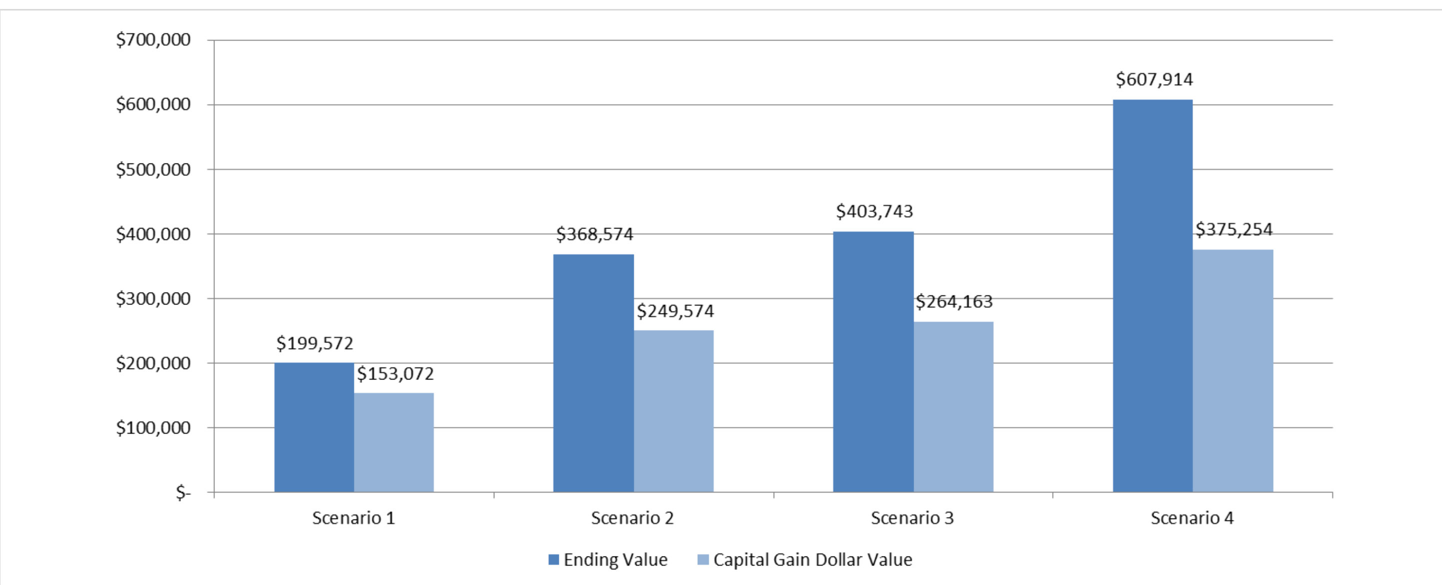
THE FUTURE OF THE TFSA: YOUNG MAN, THERE'S NO NEED TO FEEL DOWN

So, can TFSA limits grow sufficiently so that TFSAs become meaningful retirement vehicles? While the new Liberal government rolled back TFSA contribution limits for 2016 (from $10,000 to $5,500) they didn't *eliminate* new contribution room. This 2016 rollback was also very much a political strategy designed to win votes during last year's election, allowing the Liberals to differentiate their policies from the Conservatives'. In a non-election year, this is unnecessary. Also, while it's true that TFSAs are generally underutilized by Canadians, recent polls indicate that at least half of Canadians are in favour of them. The Liberals will have to be very careful in their handling of this controversial issue especially as it directly impacts voters' finances. At the very least, we believe that the potential increase to the 2017 contribution limit will remain constant with the 2016 amount (i.e., an increase of $5,500 for a cumulative total of $52,000) and may even be raised further by indexing to inflation.

Longer term, no one can forecast with any certainty the eventual actions of our government particularly as they pertain to our investments (look at how unexpected the government's income trust decision was in 2006), but it's still helpful to outline a few possible scenarios so you can assign your own likelihood to each. In the below scenarios we assume a 40-year-old investor with 25 years to retirement who begins investing with the maximum currently allowable in a TFSA ($46,500). We also assume a 6% annualized rate of return (remember: we position client TFSAs for growth, so this is not a demanding rate of return for an account focused heavily on equities). We further assume that contributions are maxed out each year.

- Scenario 1: The Liberal government and all future governments never again increase the contribution limits. The cumulative maximum contribution is frozen forever at $46,500. This is our pessimistic scenario.
- Scenario 2: The contribution limits are raised each year by $2,906—half of the average annual increase we've experienced thus far since 2009.
- Scenario 3: The contribution limits are raised each year by $2,906 and are also 'grossed up' at a 2% compound annual growth rate to account for the approximate inflation rate.
- Scenario 4: The contribution limits are raised each year by $5,812—the average annual increase we've experienced thus far since 2009—and are also 'grossed up' at a 2% compound annual growth rate to account for inflation. This is our optimistic (but not improbable) scenario.

TFSA Scenario Outcomes: TFSAs Have Value Under All Scenarios



Source: Turner Investments

While Scenario 1 is unlikely to dramatically change your retirement plans, it still certainly illustrates that the TFSA has value. However, the other scenarios begin to more meaningfully and positively affect your retirement—and remember all these capital gains are tax-free. For example, the cumulative TFSA contributions under Scenario 4, our optimistic scenario, total $232,660—the remaining $375,254 represents your 100% tax-free capital gain!

So start saving and please call us for more detailed TFSA advice because, to paraphrase the Village People, no one does it all by themselves and this thing called a TFSA can really help get you on your way. (Yes, we wrote that.)

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