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Don't rule out equities for the TFSA

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The newly launched tax-free savings account has the potential to be a very appealing long-term investment tool for affluent clients who don't need to access funds right away. Depressed equity prices are offering a unique historical opportunity for investors to maximize the upside potential of the first $5,000 they put into their TFSA.

Less than a year ago, the TFSA was greeted warmly but, for affluent clients, was viewed as little more than a value-added service. What real value is $5,000 of contribution room for a client who has hundreds of thousands of dollars of non-registered assets?

Consider, when the TFSA was announced, Canadian equity markets at least were riding high, and the fact that capital losses on investment within the TFSA could not be written off didn't make them an overly appealing equity vehicle.

Times have changed. Market prices have fallen far faster and deeper than anyone could have predicted, and they could plummet more still. There is a growing sense that the long-term upside of the market is vast — just imagine the gains if the markets were to return to where they were in the summertime — even if it takes time to get there.

This is ultimately where the greatest potential of the TFSA may be found, because $5,000 invested all in equities has arguably the greatest long-term upside potential of any horizon in history, and none of those gains will be taxed.

The risk premium on equities is lower right now, so the chances of substantial losses over a long-term horizon are greatly diminished. As markets rebound and the risk for substantial capital losses increases, the appeal of an equity strategy in the TFSA will also decline. The present offers a unique opportunity to maximize the TFSA's upside potential.

"The high-net-worth type of client has a little bit more flexibility. They may decide based on their overall portfolio they want to make use of the TFSA for interest-bearing investments. Almost everyone would want to shelter the really big gains that are hopefully coming," says Doug Carroll, vice-president of tax and estate planning for Invesco Trimark. "There could potentially be some very large gains coming when the market recovers — assuming we return to the same long-term momentum. Someone in that scenario is going to want to protect the largest gains from taxation, so equities in the TFSA would serve them better."

Due to its structure, a long-term equity strategy within the TFSA has even more profound benefits, points out Frank Di Pietro, director, tax and estate planning, with Mackenzie Investments. Contribution room is capped at $5,000 a year, but the TFSA is allowed to grow to a limitless size tax free.

This adds in the power of compounding. All of those tax-free gains can be locked in and rolled over into other investments as long as they are kept within the TFSA. Those rollovers are completely tax free. Investors have the opportunity to utilize different equity strategies as their allocation needs change.

For example, if an investor made a great call on the markets and his or her initial $5,000 TFSA investment grew to $25,000 by 2014, all of that money could be taken out of the TFSA — completely tax free. Not only that, but all of that space is now new contribution room, on top of the $20,000 of contribution room created in the meantime. This is an extremely optimistic returns scenario, but, in it, the investor would end up with double the contribution room.

"All investment income is tax free. For those where it does make sense to hold equities, there is a real powerful advantage over the long term, assuming equities outperform other asset classes, which they have over the long term," Di Pietro says. "What we're seeing is most often, because of its flexibility, the TFSA is being advertised as an emergency funding vehicle for cash, and that's not conducive to equity investing."

Indeed, this is where there are some pitfalls with equity strategies. If there is a clearly defined cash need, it doesn't make sense to lock up the TFSA into equities. For starters, Carroll points out, the TFSA is not an efficient ATM where cash can be put in and redeployed tax free. If an investor pulls money out, he or she can't recontribute until the following January 1.

This means if an investor decides to change investment strategies for the TFSA, he or she has to do it within the TFSA. If the TFSA is a GIC or high-interest savings account, and there are no equity products on the platform they are on, the investor has to look at transferring to another TFSA platform at another institution. That can be done with no tax penalties, but it can be an arduous process.

Over shorter periods, investing takes on greater downside risk, and because you can't declare capital losses, any losses sustained in a TFSA account will be greater than if they were outside the TFSA.

"You can't write off the capital losses. If you decide you're worried about things and wanted to take the money out of the equities at a loss, you've completely crystallized that loss," he says. "If your 5,000 bucks became 2,000 bucks, and you take the money out, next January, you can only add $2,000 back into the account."

On the flipside, selling equities at a loss now outside a registered account and then redeploying that money into the TFSA can make sense, says Robert Abboud, an Ottawa-based CFP.

"If you had a couple with $20,000 in a regular non-RRSP account and now it's only worth $10,000, they could sell that out, trigger the tax loss, and then move $5,000 and $5,000 to [separate] TFSA accounts. All future capital gains will be tax free. You've triggered this beautiful loss that can be used against future or past capital gains outside the TFSA," he says.

As Abboud points out, this is ideal for clients with money outside registered accounts — usually affluent clients. The majority of Canadians likely are going to want to use the TFSA to make their cash holdings more tax-efficient.

For 90% of the TFSA accounts we've done so far, it's a cash thing because they had unsheltered cash already," he says. "The equity strategy — it's a sweet situation, particularly for people who don't have cash needs."

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