Tax-Free Savings Accounts (TFSA)

By Don Nilson, CMA, FCMA

Perhaps not since the hula hoop, pet rocks and the latest Indiana Jones movie has something caused such buzz on Main Street. Everyone is talking about the new "tax-free savings accounts" ("TFSA") created in the 2008 Budget. Starting in 2009, resident individuals of at least age 18 may establish one or more TFSAs through Canadian financial institutions. This new savings vehicle has attributes similar to our existing savings regime, and some nifty new features of its own. Like RESPs, but unlike RRSPs, the capital contribution does not generate a tax break, nor is the withdrawal of capital taxed. Unlike either of them – and here is the excitement – the accumulating investment income that the account earns is never taxed! Similar to RRSPs, new contribution room accumulates annually although it is not tied to generating "earned" income. Rather, universal annual room starts at $5,000 in 2009 and is scheduled to be indexed every year in the future. You may contribute up to your accumulated room at any time in your life. Excess contributions are subject to a 1% per month penalty, as with RRSPs.

The investment rules of TFSAs generally will be the same as those that govern RRSPs, including the point that borrowing to contribute does not create deductible interest. Investment management and brokerage fees are directly deductible when incurred in a non-sheltered account, and effectively deductible when incurred in a sheltered account, but they will not be deductible for TFSA accounts.

Unlike RESPs (and special purpose education and home-buying in RRSPs), TFSA funds can be withdrawn at any time for absolutely any purpose in life. **Unlike RRSPs and RESPs, you may withdraw funds from the TFSA and replace them at any time, starting in the calendar year after the year of withdrawal.** In effect, then, your accumulating room, and accumulating income thereon, is a life-time balance in the account that can ebb and flow depending upon your needs.

Existing attribution rules between spouses are irrelevant for TFSAs because they are tax-free. Thus, one spouse can fund the other's TFSA contributions. Unlike RRSPs, however, one's own TFSA contribution room must be contributed to one's own TFSA, and cannot be "spousal".

The tax treatment of TFSAs upon death will parallel RRSPs. The account can transfer directly through a "named beneficiary" election, or indirectly through the will, to a surviving spouse and retain the tax-free character. If the TFSA is inherited by someone other than a spouse, the accumulated amount at death passes tax-free to the beneficiaries but the income earned in the account after death becomes taxable. In the case of capital assets (e.g. stocks), these will be marked to market upon the death, and only the gains (or losses) from this value will have a bearing for the beneficiary.

A related matter remains to be seen in the detailed legislation. In the case of the RRSP of a deceased, the executor can make a post-mortem RRSP contribution under the normal deadlines for the final tax year of the deceased. For a TFSA, will the executor be able to pay back funds borrowed at the time of death? This would be useful where there is a surviving spouse, who can then carry forward a larger TFSA account.

Like RRSPs, TFSAs can be transferred in marital breakup.

Unlike RRSPs and RESPs, there are no age implications to TFSAs (other than attaining age 18).

Unlike RRSPs, however, the assets in a TFSA can serve as collateral against a loan.

An interesting twist is that individuals who cease Canadian residency may maintain their TFSAs and continue to earn income free of Canadian tax. No contributions may be made, however, and no annual new room will accrue. Also, any withdrawals made whilst non-resident may not be repaid subsequently. There likely will be tax liability, however, in the new country of residence with regards to the investment income earned in the Canadian TFSA.

Who is a good candidate to use TFSAs?

People who want a rainy day fund

Everyone can build a savings pot which earns tax-free investment income until that unexpected expenditure arises.

Low income people

Conceptually, tax-free savings accounts were originally intended for people with low income throughout their working careers and retirement years. They would receive low marginal tax value from making RRSP savings while working. Then they would be penalized in retirement by turning that RRSP into a pension stream which might preclude them from receiving various income-tested social welfare benefits. Now, a TFSA can build up retirement savings without impairing access to these benefits.

In fact, it may be wise for low-income people to draw down their existing RRSPs before retirement to protect the entitlement to these social welfare benefits after retirement.

People who have topped up all of their RRSP contribution room

The TFSA provides another tax-incented savings vehicle when RRSP room is exhausted.

Parents who wish to help their adult children

In the past, parents might have assisted their children's house acquisition with a lump sum gift or loan. In the future, they might accumulate their own TFSAs to save for this purpose, or perhaps fund their children's TFSA contributions towards the same purpose. Thought should be given to whether this is a gift or a loan, and the latter ought to be documented on paper in case the child's marriage should fold; otherwise, the ex in-law may walk away with half of the money.

People who wish to accumulate funds for future large expenditures, like a house, car, return to school or family wedding

We have had a smorgasbord of savings vehicles in the past, like RHOSPs, Home Buyers' Plans and Lifelong Learning Plans. The TFSA may be a neat and tidy one-stop shopping vehicle for these purposes in the future.

Couples with disparate incomes

Tax law thwarts various income splitting schemes between couples; however, annual TFSA contributions for a low-or-no income spouse can be funded by the high income spouse, without attribution.

Parents who wish to accumulate a large education savings pool for their children

Perhaps expensive schooling is anticipated for medical or grad school or Ivy League education. RESP accumulations may not be sufficient to prepare for this. Parents could augment in their own TFSA accounts while the children are young and could contribute to their kids' accounts after age 18.

People with fluctuating incomes

It is smart to use RRSP contributions as deductions when your marginal tax bracket is high – this increases the tax break associated with the contribution. One's income might fluctuate for a variety of reasons, e.g. being in and out of the workforce, having performance-based compensation (e.g. a realtor) or having large one-time income, like capital gains on real estate. In the past, one might make that RRSP contribution (with available cash) but defer the deduction claim until a better time. A problem with this is that one doesn't know when, or if, a big income year will come. But now, it may be wiser to contribute the funds to a TFSA, earn tax-free income along the way, and withdraw the funds to make an RRSP contribution when that big income year arrives. The withdrawal from the TFSA only "borrows" from your room and can be replaced another day.

An opportunity exists for the charitably-minded who experience a high income year. They might borrow from their TFSA to make a large donation to offset their high income year. That money could be paid back to the TFSA any time in the future, or not.

Note that the relatively new, and generous, stock-gifting-in-kind tax law is irrelevant and inappropriate for any appreciated stocks in a TFSA. The capital gain in the TFSA is tax-free anyway, so this generous tax rule belongs exclusively with appreciated stocks in a Direct Trading account. On the other hand, that appreciated stock in a TFSA could be sold (tax-free) and then contribute the cash borrowed from the TFSA.

People who anticipate large estate taxes on death

Large death taxes can arise from deemed RRIF deregistration and from deemed capital gains on stocks, real estate and recreational properties. Traditionally, death taxes are funded either from liquidations in the estate wind-up or from some form of life insurance. TFSAs may cut into future insurance policy sales as a new, effective and cheaper means to fund these death taxes, as well as lower the death taxes themselves.

Recent retirees under age 71

To lighten the tax load in retirement transition, recent retirees might augment their lifestyle costs by drawing down their tax-free TFSAs instead of their sheltered accounts. This allows their sheltered accounts to compound through their '60s.

People who wish to fine-tune their financial management by addressing tax-smart investing strategies

This area is complex and depends upon your investment profile and marginal tax bracket. The topic is discussed below.

Prioritizing savings goals

For starters, it will be wise for anyone and everyone to use some TFSA room to finance their rainy day emergency fund and enjoy the tax-free aspect of this new account.

After building your emergency fund, determine your medium term savings goals and prioritize them by their timelines. For instance, if house acquisition is top of the list, ensure that both of the couple has accumulated $20,000 in their RRSPs that can

be withdrawn under the Home Buyers Plan. If not, make RRSP contributions accordingly. After this, each of the couple should save through their TFSA room, followed by a non-sheltered account.

Education savings through RESPs needs attention next. This is particularly true if your children are older – the timeline is short to contribute, use up their lifetime room and enjoy the significant 20% matching grant.

When your savings goals become long term, i.e. retirement, you need to determine what annual savings rate is required and affordable. Then determine if your annual savings rate is more or less than the sum of your TFSA and RRSP contribution room (we'll call this sum your "total room"). If your annual savings rate is less than your total room, save first in a sheltered account if you are not in a low tax bracket, and then in a TFSA. If you are in a low tax bracket, save in reverse order, starting with the TFSA. If your annual savings rate exceeds your total room, save first in a TFSA and in a sheltered account until you have used your total room, and then in a non-sheltered account.

If your ability to save precludes you from maximizing both of your TFSA and RRSP limits, then you must decide which of those two accounts will receive your scarce capital. The trade-offs between TFSAs and RRSPs include both tax-smart investing issues plus the tax break received from RRSP contributions (but not from TFSA contributions). Academic research has performed some number crunching on this and concluded that it may be a "wash", depending upon your income level.

Funding strategies

A working couple without a company pension plan could have as much as $40,000 in annual RRSP room plus $10,000 in TFSA room plus RESP room for their children at $2,500 each. This starts to add up to a lot of money – perhaps more than can be put aside in annual savings. If so, then some of the "saving" might instead be "switching". For instance, the annual TFSA contribution might be funded by transferring money, or investments, from a pre-existing taxable account. The win here is conversion of that wealth to earning tax-free instead of taxable. Note that where investments are transferred, that will be considered a disposition for tax purposes, and the treatment likely will be "one-way" – meaning that gains will be taxable and losses will be denied. As such, it would be wise to choose carefully what "things" you transfer.

Tax-smart investing strategy

This area is complex and will get interesting. Let's start with a survey of existing tax law (as it pertains to BC residents).

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Tax Treatment of Investment Income

	Non-sheltered account*	Sheltered account	TFSA
Interest	Fully taxable-annually	Fully taxable-but deferred to withdrawal	Tax-free
Dividends-eligible	Largely tax-free for incomes under $75,000 and taxable annually at rates from 8-18% thereafter	Fully taxable-but deferred to withdrawal and significant dividend tax credits lost	Tax-free but hefty dividend tax credits foregone
Dividends-ineligible	Taxable annually across all income levels at rates from 2-32%	As above, except value of foregone dividend tax credit is less	As above, except value of foregone dividend tax credit is less
Dividends-foreign	Fully taxable annually and subject to foreign tax, and foreign tax credit, of 15%	Usually exempt from foreign tax withholdings	Subject to foreign tax with-holding with no Canadian offset relief
Capital gains	One half is tax-free	Fully taxable-but deferred to withdrawal	Tax-free
Capital losses	One half is tax deductible, but only against any capital gains	Fully deductible, in effect, because the experienced loss creates less income to withdraw and pay tax on	Not tax deductible

** full details of these tax rates appear on our website at www.nilsonco.com*

The following chart ranks by column the three kinds of investment accounts by their tax treatments of various kinds of investment income.

	Most favoured	In between	Least favoured
Interest	TFSA	Sheltered	Non-sheltered
Dividends-eligible*1	Non-sheltered	TFSA	Sheltered
Dividends-eligible*2	TFSA	Non-sheltered	Sheltered
Dividends-ineligible	TFSA	Non-sheltered	Sheltered
Dividends-foreign	TFSA	Sheltered	Non-sheltered
Capital gains	TFSA	Non-sheltered	Sheltered
Capital losses	Sheltered	Non-sheltered	TFSA

**1 taxable income under approx $75,000*
**2 taxable income above approx $75,000*

There are a few practical issues with these observations. First, ineligible dividend income (from a private company) is relatively rare in sheltered and TFSA accounts. Second, dividends, capital gains and capital losses are not easily separated – they tend to come all together. So, the only totally valid tax-smart statement is that interest income is preferentially treated in a TFSA.

These observations provide us with some guidelines on how to construct tax-smart investment portfolios across asset classes.

In summary, our financial institutions all will be coming forward with their TFSA "products" in the near future. Many Canadians likely will jump on the TFSA bandwagon quickly. The size constraint of these accounts will make them administratively unprofitable for the financial institutions for a long while. Those same size constraints also will minimize and delay the overall impact on Canadians' wealth picture.

To paraphrase and modernize a saying of 16th Century *Sir Francis Bacon:* **Family finances, to be commanded, must be obeyed.** Those who seek to manage their finances need to pay attention to this new "kid on the block" – TFSAs.

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