Tax-Free Savings Accounts – Plan overview

The Tax-Free Savings Account (TFSA) is a flexible, registered account that allows Canadians to watch their investments, including interest income, dividend payments and capital gains, grow tax-free. Whereas an RRSP is intended for retirement, the TFSA can be effective for achieving pre-retirement, retirement and estate planning goals.

This InfoPage summarizes the features and benefits of the plan.

Eligibility

Age 18 or older

Starting in 2009, all Canadian resident taxpayers at least 18 years old will be allowed to open up a TFSA. The only other requirement is that the individual must have a Social Insurance Number (SIN) when the account is opened.

Application checklist

The TFSA must have its own application form, separate from other account types. In completing the form, be sure to double check that you have correctly recorded your surname, SIN and date of birth, as CRA has warned that if these items do not match with its records, the plan will be deregistered and tax will be payable on any earnings which may have occurred in the plan to that date.

Contributions

Contribution room beginning January 1, 2009

Each eligible individual will be entitled to the initial annual limit of $5,000 of TFSA contribution room in 2009.

Annual indexing

An indexing formula will be applied annually to determine whether the TFSA contribution room will increase. The resulting figure will be rounded to the nearest $500. For example, if the calculation for 2010 yields a figure of $5,200, then room for 2010 will remain at $5,000. If the 2011 calculation brings it to $5,400, then the actual 2011 room will be $5,500.

Unlimited carryforward

Contribution room is cumulative and will be carried forward indefinitely to future years. For example, if you can only afford to contribute $2,000 in 2009, your TFSA contribution room will be $8,000 in 2010 ($3,000 carried forward from 2009 plus $5,000 as your annual entitlement for 2010).

Recovery of contribution room

Unlike the RRSP system where contribution room is completely exhausted as it is used, any amounts withdrawn from your TFSA in a particular year are automatically added to your TFSA contribution room for the following year (and again may be carried forward indefinitely). Fitting with the flexible, general-purpose nature of the account, this will allow individuals to re-contribute an equivalent amount in a future year.

Tax structure

Funding using after-tax money

Unlike RRSPs but similar to RESPs and the recently introduced Registered Disability Savings Plans (RDSPs), contributions to a TFSA are after-tax funds, which is to say that those contributions are not tax deductible from income.

Tax-sheltering within the plan

Whether the chosen investment within the TFSA earns interest income, dividend payments or capital gains, there is no tax to be paid on those earnings.

Withdrawals are not taxable

Whereas RRSP or RRIF withdrawals are fully taxable, there is no tax paid on TFSA withdrawals. As well, at no time is there a minimum or maximum withdrawal amount, nor are there any requirements or restrictions on what you do with those withdrawals. And remember: any withdrawals actually taken will cause a dollar-for-dollar recovery of contribution room to be used in the future.

Stage	RRSP	TFSA
Tax-free funding	✓	no
Tax-free growth	✓	✓
Tax-free withdrawals	no	✓

Investment options

A TFSA will be allowed to invest in the same broad list of qualified investments permitted for RRSPs, including stocks, bonds and mutual funds.

Excess contributions

Just like with RRSPs, any excess contributions beyond the TFSA contribution limit will be taxed at 1% per month.

Effect on income-tested government benefits

A significant drawback to receiving RRSP-sourced income is that the holder is not only taxed on that income, but those receipts can affect eligibility for income-tested government benefits (such as the Guaranteed Income Supplement or Old Age Security) and tax credits (in particular, the Age Credit, Canada Child Tax Benefit and Goods and Services Credit). In stark contrast, TFSA withdrawals are not income and therefore will not contribute to the loss of those income sources or tax credits.

Strategic use of TFSAs

Interest deductibility

Since the income earned inside a TFSA along with TFSA withdrawals are non-taxable, you won't be able to write off any interest expense on funds borrowed for the purpose of investing in a TFSA.

As loan collateral

Unlike RRSPs, which cannot be used as collateral for a loan (unless you want your RRSP deregistered and immediately taxed), TFSA assets can be used as collateral, which may facilitate investors obtaining secured credit for other purposes at more favourable rates.

No spousal income attribution

Where an individual contributes to a non-registered investment of a spouse or partner, the income attribution rules will attribute taxation back to the contributor. The TFSA rules contain a specific exception to these attribution rules, effectively creating a new avenue for spousal wealth planning.

What happens upon death?

The fair market value of the TFSA on the date of death will be received by the estate on a tax-free basis; any income or gains accruing after the date of death will be taxable. The ability to name a direct beneficiary on a TFSA will depend on future amendments to provincial laws allowing for such designations.

Rollover to spouse

An individual may designate a surviving spouse or partner as a successor account holder to continue the particular TFSA or transfer the value to the survivor's own TFSA. Either way, the account continues to be tax-exempt and there is no effect on the survivor's own existing TFSA contribution room.

What happens upon separation or divorce?

On the breakdown of a marriage or a common-law partnership, any TFSA amount may be transferred from the TFSA of one spouse or partner to the TFSA of the other while maintaining the tax-exempt status. Such transfers do not recover contribution room for the transferor, nor do they affect the existing room of the transferee.

What if you become a non-resident?

If you become a non-resident, you can still hold your TFSA and continue to benefit from the tax exemption on investment income and withdrawals, but no contributions will be permitted nor will TFSA contribution room continue to accrue. Any contributions made during non-residency will be subject to a 1% penalty per month for each month these funds remain in the plan.

For more information about this topic, contact your advisor, call us at 1.800.874.6275 or visit our website at www.invescotrimark.com.

TFSAs vs. RRSPs

While the plans are meant to be tax-neutral where a person has the same marginal tax rate at all times (see chart below), RRSPs will tend to make more sense when the tax rate upon withdrawal is expected to be lower than your tax rate upon original contribution. Conversely, TFSAs will work out better if your tax rate (including the effect of RRSP withdrawals on reduced income-tested benefits) will be higher upon ultimate withdrawal than it was when you contributed.

TFSAs compared to RRSPs at a constant income tax rate

	RRSP	TFSA
Pre-tax income	$1,000	$1,000
Tax on contribution (40%)	N/A	(400)
Net contribution	1,000	600
Growth at 6% over 20 years	3,207	1,924
Tax on withdrawal (40%)	(1,283)	N/A
Net cash	**$1,924**	**$1,924**
Where there is a tax rate differential between the year you contribute and the year you withdraw	High to low favours RRSP	Low to high favours TFSA

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