Tax-Free Savings Accounts

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The two greatest impediments to the accumulation of savings and net worth over the long term are inflation and taxes. And, while there's not a lot the average Canadian can do about the former, it is possible to minimize the tax bite by saving through one of the tax-deferred savings vehicles provided under Canada's tax system.

Our tax system provides for a few such vehicles, but the most recent one—the tax-free savings account, or TFSA—may ultimately prove to be the best. The TFSA combines a number of the features found in other tax-deferred savings plans, like registered retirement savings plans (RRSPs) or registered education savings plans (RESPs), but it provides a degree of flexibility that neither of those types of plans can match.

Who can open a TFSA?

Essentially, any Canadian resident can open a TFSA as soon as he or she turns 18 years of age. A plan cannot be opened until after one's 18th birthday but, once opened, it is subject to the same rules with respect to annual contributions as a full-year plan.

In order to open a TFSA, it's necessary to have a Social Insurance Number (SIN), which most Canadians already have by the time they turn 18. As well, because of the tax-deferred nature of the plan, that SIN and one's date of birth must be provided to the plan administrator when the TFSA is opened.

TFSAs are offered by just about every Canadian banking institution and, as is the case with RRSP deposits, the banks and other financial institutions are often prepared to offer favourable rates of interest in order to attract and keep consumers' business.

In any year after 2009, a taxpayer's maximum possible contribution to a TFSA is the total of the following three amounts:

- the annual TFSA dollar limit ($5,500 per year plus indexation, if applicable; from 2009-2012, the limit was $5,000 per year, and in 2015 it was $10,000);
- any unused TFSA contribution room in the previous year; and
- any withdrawals made from the TFSA in the previous year, excluding qualifying transfers. Such qualifying transfers are those made to a spouse or former spouse's TFSA as a consequence of the breakdown of the marriage.

Putting money into a TFSA

Annual TFSA dollar limit

Each Canadian who is eligible to open a TFSA can contribute up to $5,500 per year to that plan or plans, and it's possible to have any number of TFSAs, as long as the total contribution to one's plans doesn't exceed one's overall limit for the year. Unlike RRSPs, the ability to contribute funds to a TFSA does not depend one one's income – the $5,500 contribution amount is available to anyone who is otherwise eligible to contribute to a plan, regardless of their income. As well, where a plan is set up by a taxpayer in the year he or she turns 18 and is first eligible to contribute, the full $5,500 contribution limit is available; in other words, there is no pro-ration required for the portion of the year before the taxpayer turned 18.

The $5,000 annual contribution room limit applied from the 2009 taxation year until the end of 2012. That contribution room limit was indexed to inflation for 2013 and 2014, with the indexed amount rounded to the nearest $500, setting the limit to $5,500. In 2015, the limit was increased to $10,000. Effective January 1, 2016, the annual limit was returned to $5,500, and is indexed to inflation for each year after 2015, rounded to the nearest $500.

Carryforward of TFSA contribution room

As is the case with RRSPs, amounts not contributed to a TFSA in a particular year can be carried over and contributed in any subsequent year.

There is no limit on the number of years for which an unused contribution amount can be carried forward, nor is there any limit on the amount of carryforward room. For instance, a taxpayer who made no TFSA contributions during the next 10 years that he or she is eligible to do so would have (without indexing) $55,000 ($5,500 × 10 years) in unused contribution room, all of which could be contributed in year 11.

Recontribution of withdrawn amounts

When it comes to withdrawals, TFSAs provide a tax benefit which neither RRSPs nor RESPs can match. Simply put, money (whether original contributions or investment income earned) can be withdrawn from a TFSA at any time, in any amount and for any purpose, free of tax. And, once funds are withdrawn, the amount of any withdrawal (including amounts which arose from investment gains) is added to the taxpayer's contribution room amount for the following year.

A taxpayer contributes the maximum of $5,500 to a TFSA in 2016. Those funds are used to purchase shares which, over the subsequent two years, increase in value to $12,000. In 2018, the taxpayer sells the shares still held in the TFSA and realizes a tax-free capital gain of $6,500. The full $12,000 is then withdrawn and, once again, no tax is payable on the withdrawal. The taxpayer's contribution room for 2019 is now increased by the amount of the previous year's withdrawal, bringing total contribution room for 2019 to $17,500, comprising $5,500 of current year contribution room plus the $12,000 withdrawal from 2018.

It's apparent from the example that the ability to "top-up" one's TFSA by the amount of any withdrawal, means that potential contributions (and therefore potential tax-free investment gains) can significantly exceed the $5,500 annual contribution limit.

While the concept of a $5,500 annual contribution limit is simple enough, the combination of annual limit, carryforward amounts, and re-contribution of withdrawals can be confusing. The Canada Revenue Agency (CRA) provides the following example (which does not take indexing into account) of how those amounts can combine to create a taxpayer's overall current year contribution limit.

In 2016, Carl is allowed to contribute $5,500. He contributes $2,000 for that year.

2016 TFSA dollar limit: $5,500

2016 contributions: ....- $2,000

Unused TFSA contribution room

available for future years $3,500

In 2017, Carl does not contribute to his TFSA, but he makes a $1,000 withdrawal from his account.

2016 unused TFSA contribution room...............$3,500

2017 TFSA dollar limit ....+ $5,500

2017 unused TFSA contribution room available for

future years $9,000

Carl's unused TFSA contribution room for 2018 is calculated as follows:

2017 unused TFSA contribution room ....+ $9,000

2017 withdrawal .... + $1,000

2018 TFSA dollar limit ....+ $5,500

2018 TFSA contribution room $15,500

Taxation of TFSAs

From a taxation perspective, TFSAs have features of both RRSPs and RESPs and, in some ways, combine the best of both.

Funds contributed to a TFSA are not deductible from the contributor's income in the year the contribution is made. Consequently, unlike an RRSP, a TFSA contribution is not going to reduce one's tax liability for the year or create or increase a tax refund. However, as is the case with both RRSPs and RESPs, there is no tax payable on investment income earned by funds held within a TFSA. That rule applies regardless of the type of investment income earned – interest income, dividends, and any capital gains earned on the sale of property held within a TFSA are all exempt from tax.

Perhaps most significantly, and unlike funds held in an RRSP or an RESP, TFSA funds (including both original contributions and investment gains) can be withdrawn from the plan free of tax at any time and in any amount by the planholder, and there are no restrictions on the use to which such withdrawn funds can be put.

Spouses, adult children, and TFSAs

The *Income Tax Act* contains a set of rules, known as the attribution rules, which seek to prevent transfers of assets and income between family members generally, and spouses in particular, in order to create a tax savings or advantage. In most cases, those rules work by "attributing" any income earned on such transferred funds back to the transferor and taxing them in his or her hands.

One of the benefits of TFSAs is that the attribution rules do not apply to such transfers made for the purpose of contributing to a TFSA. It is therefore possible for any member of a family to provide funds to other family members (whether spouses or adult children) to enable them to make a TFSA contribution. Once that contribution is made (within the contribution limit of the spouse or child making the contribution), those funds and any investment income earned are treated as belonging to the spouse or child who made the contribution and all

the usual TFSA rules with respect to investment income earned and the tax-free status of withdrawals apply. Since each Canadian resident 18 and over can make a contribution of up to $5,500 in a year, the total possible annual contribution for a family of four which includes two adult children is, therefore, at least $22,000.

Where there is a marriage breakdown and one spouse or both hold funds within a TFSA, those funds can be transferred directly between the plans of each spouse without any tax consequences or any effect on the ability of each spouse to make an "ordinary" contribution to a TFSA in the year the transfer takes place.

Investing TFSA funds

As a general rule, funds contributed to a TFSA can be invested in much the same types of investments as are available for RRSP contributions. For most Canadians, such investments would include mutual funds, guaranteed investment certificates (GICs), bonds, and shares which are listed on a "designated" stock exchange, which would include most Canadian and most major foreign exchanges. It's also possible to contribute cash to a TFSA, in either Canadian or foreign funds. However, where the contribution is made in foreign funds, those funds must be notionally converted to Canadian dollars for purposes of computing one's annual contribution limit and reporting on contributions to the CRA. In other words, a taxpayer's contributions cannot be greater than his or her annual limit in Canadian dollars.

As with RRSPs, "in kind" contributions—for instance, qualifying shares already held by the taxpayer—can be made to a TFSA. Where such contributions are made, the amount of the contribution is calculated as the fair market value of the property at the time it is contributed. For general tax purposes, the contribution of property to a TFSA will be considered to be a disposition of that property by the contributor. Consequently, where the property has appreciated in value since its original acquisition, the taxpayer will, in the year the contribution is made, have to report that capital gain on his or her tax return for the year. However, the converse is not true—even if the property has declined in value since its acquisition, the taxpayer cannot claim a capital loss arising from the property's disposition when it was contributed to the taxpayer's TFSA.

TFSA withdrawals and income-tested government benefits

Where income is received by a taxpayer during the year, in addition to being subject to tax, it can affect both the recipient's eligibility for certain income-tested benefits and his or her eligibility for certain tax credits. And, while these considerations can affect taxpayers of any age, they are a particular concern for taxpayers over the age of 65.

Eligibility for the federal goods and services tax credit, the working income tax benefit, and the Canada Child tax benefit is based on the potential recipient's income for the current or previous taxation year. As well, certain other benefits, like Old Age Security, the Guaranteed Income Supplement, and Employment Insurance benefits are reduced as income increases. Finally, eligibility for the federal age credit begins to be eroded where a taxpayer's income (for 2016) is more than $35,927, and eligibility for the credit is lost once income reaches $83,427.

Happily, none of these limitations or thresholds is a concern when it comes to earning money within or taking money out of a TFSA. Neither earnings within a plan or amounts withdrawn from it will affect eligibility for any of the federal income-tested benefits and credits outlined above. And, while rules are not uniform across Canada, most of the provinces have indicated that they will follow the federal practice and not consider TFSA income when determining eligibility for similar provincial benefit and credit programs.

Finding out your TFSA limit

Issuers of TFSAs are required to provide the CRA with information on the amounts contributed to and withdrawn from a TFSA by individual taxpayers (hence the requirement that anyone opening a TFSA must provide a social insurance number). The CRA will then use that information to determine TFSA contribution room for each individual taxpayer for a given year. That information will be provided to the taxpayer as part of his or her Notice of Assessment, which is typically issued by the CRA in the spring or early summer, following the annual tax-filing season. As is now the case with most individual tax information, it will also be possible to find out what one's current year TFSA limit is from the CRA Web site, or by calling the Agency's individual inquiries line at 1-800-959-8281.

Penalty taxes

The best reason for being aware of just how much one can contribute to a TFSA in any given year is the penalty tax which will be imposed where an over-contribution (inadvertent or otherwise) is made. That penalty tax is equal to 1% per month of the highest excess amount during that month, continuing for every month that the taxpayer is in an overcontribution position.

Does it make sense to borrow to contribute to a TFSA?

Given all the benefits to be obtained, most taxpayers would rightly conclude that making a TFSA contribution is almost always a good idea. However, it's not always the case that a taxpayer's cash flow permits a contribution to be made and, in such circumstances the question of borrowing to make the contribution arises.

Taxpayers are frequently advised that borrowing to make an RRSP contribution can make sense where the loan can be paid off in the short term. However, it's also the case for an RRSP, unlike a TFSA, that making a contribution, even with borrowed funds, will reduce the taxpayer's tax liability of the year, or even create or increase a refund which can be used to pay down the loan. Given that no deduction from income can be claimed for a TFSA contribution, it's much harder to make the case for borrowing to contribute. Such borrowing probably makes sense only in the (unlikely) case that the cost of borrowing is less than the return which can be expected on the funds to be contributed to the TFSA over the same time period. As well, since there is no real annual deadline for TFSA contributions, such as exists for RRSPs, there's no pressure to come up with the required contribution by a certain date. In most cases, it's likely a better idea to put a smaller amount into one's TFSA each month throughout the year, using the funds which would otherwise have gone to loan repayment, and avoiding the (non-deductible) interest cost altogether.

Death of a TFSA holder

On the death of a planholder, the rules governing the treatment of TFSA funds are, for the most part, the same as they were during the planholder's lifetime. Any funds (whether original contributions or investment gains) which have accrued during the planholder's lifetime can be paid to the estate free of tax. Gains which accrue after the death of the planholder are taxable in the hands of the beneficiaries who receive them.

In many cases, a planholder will have specified that his or her spouse, rather than his or her estate, is to receive all TFSA funds. Where that is the case, the TFSA continues and the spouse or common-law partner simply steps into the shoes of the deceased and becomes what is termed the "successor holder" under the plan.

TFSA or RRSP?

The introduction of TFSAs as part of the 2008 federal budget gave taxpayers an additional choice when it came to tax-assisted savings beginning with 2009, and both options also involve the possibility of contributing carryforward amounts.

It is not, of course, an either/or choice. Taxpayers can (and probably should) utilize both the RRSP and TFSA options in planning their financial affairs. Realistically, however, for most taxpayers the limitation is one of resources and cash flow, and it's often not possible to fund contributions to both an RRSP and a TFSA in the same year. That said, where a choice must be made between the two, what are the considerations which apply in determining which savings/investment vehicle to choose? As with nearly all tax-planning questions, the answer depends almost entirely on the financial and tax circumstances of the individual taxpayer. However, for taxpayers in particular age or income groups, there are some general rules-of-thumb which provide some guidance.

- The minority of working taxpayers who are members of registered pension plans will likely find the TFSA option particularly attractive. The maximum amount which can be contributed to an RRSP for the 2016 tax year is calculated as 18% of earned income for 2015, to a maximum contribution of $25,370. However, that maximum contribution is reduced, for members of RPPs, by the amount of benefits accrued during the year under the pension plan. Where the RPP is a particularly generous one, RRSP contribution room may be minimal, and a TFSA contribution becomes the logical alternative.

- In a similar way, for taxpayers over the age of 71, the RRSP vs. TFSA question is simply irrelevant. Taxpayers over that age are not eligible to make contributions to an RRSP, making TFSAs the only tax-free savings vehicle to which they can make contributions. In fact, the federal government's estimate, when it introduced TFSAs was that, based on current savings patterns, half of the savings which would be realized through the use of TFSAs will be received by seniors. The benefit is greatest for older taxpayers whose required RRIF withdrawals are greater than their current needs. While such RRIF withdrawals must be included in income and taxed in the year of withdrawal, transferring the funds to a TFSA will allow them to continue compounding free of tax and no additional tax will be payable when and if the funds are withdrawn, for whatever purpose. And, unlike RRIF or RRSP withdrawals, monies withdrawn from a TFSA will not affect the planholder's eligibility for Old Age Security benefits or for the federal age credit.
- For younger taxpayers, where the savings goal is short-term—for example, a down payment on a home or paying for next year's vacation, the TFSA is clearly the better choice. While choosing to save through an RRSP will provide a deduction on that year's return and probably a tax refund, tax will still have to be paid when the funds are withdrawn from the RRSP a year or two later. And, more significantly from a long-term point of view, using an RRSP in this way will eventually erode one's ability to save for retirement, as RRSP contributions which are withdrawn from the plan cannot be replaced. While the amounts involved may seem small, the loss of compounding on even a small amount over 25 or 30 years can make a significant dent in one's ability to save for retirement.
- Taxpayers who are expecting their income to rise significantly within a few years—for example students in post-secondary or professional education or training programs—can save some tax by contributing to a TFSA while they are in school or during subsequent professional apprenticeship periods and enjoying the benefit of tax-sheltered growth. Once they graduate and are working (when their income and therefore their effective tax rate will increase) funds can be withdrawn tax-free from the TFSA and used to make an RRSP contribution. That contribution can then be deducted against income which would otherwise be taxed at the much higher rate, generating a tax savings. And, if a need for the funds should arise in the meantime, a tax-free TFSA withdrawal can always be made.
- Similarly, taxpayers who experience a temporary drop in income—perhaps through job loss or even a short-term lay-off or reduction in hours resulting from a recession—may not be likely to gain a great deal from the tax deduction provided by an RRSP contribution. In such circumstances, the taxpayer would likely be better off contributing any available funds to a TFSA for the short-term to benefit from the tax-sheltered growth of those funds inside the plan. When the taxpayer's income is back to pre-recession levels—consideration can be given to withdrawing the funds from the TFSA and contributing them to an RRSP to offset the tax payable on that higher income.
- Financial planners and tax advisers are accustomed to being asked by clients whether it makes more sense to pay down the mortgage (or other debt) or to contribute to an RRSP. That question has become more complicated now that the TFSA option has been added to the mix. There is, however, still a solution which allows the taxpayer to do both. Assuming a marginal tax rate of 45%, an RRSP contribution of $11,000 will generate a tax refund of $4,950, allowing the taxpayer to make his or her maximum annual TFSA contribution. Alternatively, the refund can be used to pay down the mortgage or other debt, or it can be split between the two options.

Conclusion

Despite their many advantages, TFSAs seem to have gotten off to a slow start with the Canadian public, as Canadians continue to make the RRSP their first choice as a vehicle for savings. And, while no one would suggest that RRSPs shouldn't be a part of a long-term retirement savings plan, the flexibility of TFSAs should afford them a place in everyone's investment and retirement planning strategy.