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Tax Bulletin

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Answering Your TFSA Questions

In the 2008 federal budget, the Minister of Finance introduced a new savings plan for Canadians—the Tax-Free Savings Account or TFSA. Although the TFSA will share a number of definitions and rules with other plans such as a registered retirement savings plan (or RRSP), there are some important differences.

Unlike RRSPs, the TFSA will be a tax-paid savings vehicle. It will allow individuals to save for many purposes, such as buying a home, starting a small business, buying a new car or putting money away for a child's wedding. TFSAs will also be a lot more flexible than an RRSP, as you'll be able to put money in or take money out without impacting your ability to use a TFSA again in the future. RRSPs are ill-suited for these shorter term savings goals. And TFSAs can also be used to save for retirement. In fact, for some individuals, having a TFSA at retirement may be more beneficial than an RRSP as TFSA withdrawals won't impact income-tested benefits.

What makes a TFSA significantly different than other tax deferred plans such as an RRSP is how contributions and withdrawals are handled. Unlike an RRSP, contributions to a TFSA will not give rise to a tax deduction (and that's why we say a TFSA represents tax-paid savings). When money is withdrawn, the accumulated contributions and income you receive will not be taxable.

In the rest of this bulletin, we'll address many of the common questions people are asking about the TFSA.

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Opening a TFSA

Who can open a TFSA and when?

The rules for TFSAs became operative on January 1, 2009. Any individual (other than a trust) who is resident in Canada and 18 years of age or older can open a TFSA. Like an RRSP, you can hold as many TFSA accounts as you want as long as you do not exceed the contribution limit.

Where can I buy a TFSA?

Although it will be up to individual financial institutions to decide on whether they will offer TFSAs, you should be able to open a TFSA account at most financial institutions, such as Canadian trust companies, investment dealers, life insurance companies, banks, and credit unions (basically the same institutions that currently offer RRSPs). You will have to provide the institution with your social insurance number when the account is opened. The availability of self-administered TFSAs may be more restricted.

Contributing to a TFSA

How much can I contribute?

The amount you can contribute annually will be governed by your contribution room for the year. Your TFSA contribution room will be made up of three amounts:

- The annual contribution room for the year. Each year, you will be entitled to a contribution limit of $5,000. According to the government, this limit will be indexed to inflation and rounded to the nearest $500 on a yearly basis. With our current low inflation rates, the limit will likely be $5,000 for the first 2 or 3 years.
- Any withdrawals made in the previous year will be added to the contribution room for the year.
- Any unused contribution room from the previous year will be added to the contribution room for the current year.

To illustrate the rules, consider the following example (indexing has been ignored). In 2009, you'll be allowed to contribute up to $5,000. So, if you only contribute $2,000 in 2009, that will mean that you can carry forward the remaining $3,000 of contribution room to 2010, giving you 2010 contribution room of $8,000 (the annual limit for 2010 of $5,000 plus the $3,000 carried forward). Next, let's say you withdraw $1,000 in 2010 (and you don't make a contribution during the year). This will give you contribution room in 2011 of $14,000 (being the annual limit for 2011 of $5,000, plus the $8,000 carried forward from 2010 and the $1,000 you withdrew in 2010).

How will I know what my TFSA contribution room will be?

Although calculating the TFSA contribution room may seem complicated, there is good news. The Canada Revenue Agency (CRA) has said it will track TFSA room in the same sort of way that it currently tracks RRSP contribution room. Based on information provided by TFSA issuers, the CRA will determine your TFSA contribution room. Your annual contribution room will be indicated on your notice of assessment.

What if I overcontribute to a TFSA?

TFSA overcontributions will be subject to a 1% penalty tax per month in the same way as RRSP overcontributions. However, in the case of the TFSA, there will not be a $2,000 margin for error which is available for RRSP overcontributions—the first dollar of TFSA overcontributions will be penalized. So, you will have to track your TFSA limit and carefully compare it to the contributions you make. We anticipate that the CRA will track TFSA overcontributions.

I'm a U.S. citizen living in Canada. Should I make a TFSA contribution?

The main issue that has to be considered here is that U.S. citizens and other "U.S. persons" such as green card holders are subject to U.S. tax on their worldwide income. Under the current Canada-U.S. Tax Treaty, U.S. persons in Canada can elect to defer income earned in certain plans such as an RRSP, registered retirement income fund or a deferred profit sharing plan for U.S. tax purposes until it is withdrawn. This is because current income in these plans is exempt from tax in Canada and each plan was "operated exclusively to provide pension or employee benefits". As TFSA contributions and withdrawals are in no way linked to employment or retirement, it appears that treaty relief will not apply to TFSAs. This would mean that TFSAs will be treated as an ordinary investment account for a U.S. person and therefore, TFSA earnings would be part of a U.S. person's taxable income for U.S. purposes. If you're a U.S. person, the best advice would be to consult with your BDO advisor before purchasing a TFSA.

Can I gift or loan funds to a spouse or other family members to make TFSA contributions?

Yes. Generally, if you make an interest-free loan or gift funds to a spouse to invest, the income on the investment will be attributed to you and taxed in your hands. In the case of funds used by your spouse to make a TFSA contribution, there will be no taxable income, and therefore, the attribution rules will not be a concern. The same will be true where you make an interest-free loan or a gift to an adult child so that they can invest in a TFSA. Loaning or gifting money to family members to buy a TFSA will become an important personal tax planning consideration.

Investing and managing your TFSA

What kind of investments can I hold in my TFSA?

A TFSA will generally be permitted to hold the same investments as an RRSP, including mutual funds, publicly traded securities, GICs, bonds, and certain shares of small business corporations. Note that unlike RRSPs, there are additional rules for investments that are not available on the open market.

The specific investments available to you could also be governed by the terms of your TFSA agreement with your financial institution. You will be subject to penalties on any investments which are not permitted to be held in your TFSA.

I currently hold shares of a private corporation in my RRSP. Can I hold the same type of investment in my TFSA?

Under the rules for RRSP investments, it is possible to hold shares of a private company in your RRSP. There are several conditions that have to be met, and one key rule is whether the corporation is controlled by you or your family as a group, as family controlled corporations are not eligible.

When it comes to a TFSA investment, you should keep in mind that more restrictive rules apply. As the ability to accumulate growth on a tax-free basis is a significant advantage, the government has introduced rules that are designed to block investments that provide a return or other features that would not normally be available for open market investments. For example, if you hold an investment where the nature of the investment is such that it would only be available in special circumstances, then that investment may be problematic. As a specific example, the CRA recently said that this would be the case where a business owner completes an estate freeze so that key employees can buy shares of a private company. The rules for investments that do not trade publicly are complicated, and you should always consult your BDO advisor before holding these investments in a TFSA.

I'm putting money aside for my next car. If I use a TFSA next year, will that mean I can't use a new plan later to save for a house?

No. As discussed earlier, your TFSA contribution room will include amounts withdrawn in a previous year from any of your TFSAs. Therefore, if you fully use your TFSA room over the first two years, and collapse your TFSA when it is worth $12,000, you'll be able to put that $12,000 back into a new TFSA in a subsequent year when you begin to save for your house (plus the annual TFSA contribution room that accumulates by then). So, you will be able to use a TFSA repeatedly over the course of your lifetime to save for different purposes.

I have RRSP contribution room and I still owe money on a recent home purchase. Should I invest in a TFSA, make an RRSP contribution or pay off my mortgage?

This is definitely a difficult question to answer as there was never a "one size fits all" answer on the RRSP contribution vs. mortgage repayment issue. So, the answer will vary even more now that TFSAs have been added to the mix. That said, there are a number of observations that can be made:

- If you make an RRSP contribution, this will, for most employed individuals, create a tax refund that you can use to pay down your mortgage. Many financial advisors suggest this approach as you are making progress toward both paying off your mortgage and saving for your retirement. A TFSA contribution will not produce a tax refund.
- The issue of whether an RRSP or TFSA is better for you will really depend on what your marginal income tax rate is now and what it will be in retirement. For example, if you are in a high bracket now, and will be in a lower bracket later, RRSP contributions effectively move income that would be taxed at a high rate now into a lower tax bracket later. This produces both a tax deferral and a tax saving.
- Where an individual is in a lower tax bracket now, and expects to be in the same lower tax bracket later on retirement, a TFSA might make more sense than an RRSP, as the use of an RRSP

could put the individual into a higher bracket in retirement while a deduction arises now at a low marginal rate. Also, having lower income in retirement may allow you to keep more of your government benefits that are income-tested such as Old Age Security, Guaranteed Income Supplements, GST credits and other benefits/credits.

- When comparing a TFSA contribution to making a mortgage repayment, your mortgage is really just another TFSA. That is, any non-deductible interest that you don't have to pay due to the mortgage repayment is effectively tax-free income earned with a fairly good return on your money. Therefore, in terms of limiting risk, many individuals will concentrate on repaying their mortgage first, especially since the accumulated TFSA room should still be there when they finish paying off their mortgage. If your investment rate of return is less than the mortgage rate, then paying down your mortgage will definitely be more beneficial.
- If you have funds now, but you may need them again later, using a TFSA temporarily could make sense. Contributing money to an RRSP now and withdrawing it soon after is usually not a good idea. Although the income and deduction may offset each other (i.e. if the contribution and withdrawal fall within the same year), this eliminates RRSP room. If you're in this situation, a better plan could be to put the money into a TFSA and then later transfer the funds to an RRSP as a contribution once you're sure you won't need the money until retirement (assuming of course using an RRSP makes sense for you in general).
- Finally, many financial advisors recommend that individuals keep a reserve fund for a rainy day. The TFSA is perfectly suited to this as your reserve fund will not be taxed, and if you do have to draw on it, then you can put the money back in a later year when financial resources permit.

Rules on death, marriage breakdown and emigration

How will a TFSA be handled on death or marital breakdown?

Generally, earnings that accrue before your death will remain tax-exempt, while earnings that accrue after your death will be taxable.

It is possible to maintain the tax-exempt status of earnings. In the case of a surviving spouse, it will be possible to transfer a TFSA to the spouse without affecting the spouse's TFSA contribution room. This can be accomplished by simply naming the spouse as the successor account holder as part of the plan. Alternatively, the assets of a deceased individual's TFSA can be transferred to a TFSA held by the surviving spouse.

The same sort of rules will apply on marital breakdown. That is, if TFSA property is transferred between spouses on marriage breakdown, it will again be eligible for TFSA treatment in the hands of the transferee without affecting their TFSA room.

What happens if I emigrate from Canada?

If you become a non-resident of Canada, you will be allowed to maintain your TFSA, and you will not be taxed on any earnings in the account or on withdrawals in Canada. However, no contribution room will accrue for any year throughout which you are a non-resident and any contributions you make will be subject to penalty. You will also need to determine how the TFSA will be treated under the tax laws of the country you emigrate to.

Borrowing considerations

Should I borrow to make a TFSA contribution?

Probably not. In the case of an RRSP, it has been suggested that borrowing money for an RRSP contribution and paying non-deductible interest for a few months can make sense if you borrow just before the RRSP contribution deadline and you will pay off the loan quickly. This is because a last minute RRSP contribution will provide a tax reduction now that you wouldn't otherwise get until next year. In the case of a TFSA contribution, it will not generate a tax deduction and any interest paid will also be non-deductible.

In the case of a terminally ill individual with a spouse or an individual who will emigrate from Canada it could make sense to borrow money to make a TFSA contribution. In the case of death, a TFSA account can be transferred to a surviving spouse while TFSA room can not. The surviving spouse can pay off the loan with other funds that arise after death or even simply collapse the TFSA (as the withdrawal will be added to the surviving spouse's TFSA room for future years). For an emigrant, they will not be able to make a contribution after emigration even though they will keep unused

TFSA room should they resume their Canadian residency in the future. Therefore, borrowing funds for a contribution may be worthwhile, especially where the TFSA will not be subject to tax in the country in which the emigrant is resident.

Summary

The TFSA will become an important part of Canadian personal tax planning as TFSA room begins to accumulate. If you have any questions on these rules, contact your BDO advisor.

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