

## Tax-free savings accounts (TFSA)

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A 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 a registered retirement savings plan (RRSP) is intended for retirement, a TFSA can be effective for achieving pre-retirement, retirement and estate planning goals.

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### Eligibility

#### Age 18 or older

Since 2009, all Canadian resident taxpayers at least 18 years old have been allowed to open 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, an individual should be sure to double-check that his or her surname, SIN and date of birth are correctly recorded, as the Canada Revenue Agency (CRA) has warned that if these items do not match with its records, the account will be deregistered and tax will be payable on any earnings that may have accrued in the account to that date.

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### Contributions

#### Annual contribution room beginning January 1, 2009

Each eligible individual is entitled to the initial annual "TFSA dollar limit" of \$5,000 in contribution room for 2009. The eligible individual is also allocated an annual TFSA dollar limit for each year thereafter (indexed for inflation).

#### Annual indexing

An indexing formula is applied annually to determine whether the annual TFSA dollar limit will increase. The resulting figure is then rounded to the nearest \$500. As of 2013, the annual TFSA dollar limit increased to \$5,500 from \$5,000 as a result of indexation. As an example, if the calculation for 2018 yields a figure of \$5,700, then the dollar limit for 2018 will remain at \$5,500. If the 2018 calculation brings it to \$5,800, then the 2018 dollar limit will be indexed to \$6,000.

### Changes to the annual TFSA dollar limit

In the 2015 Federal Budget, the federal government increased the annual TFSA dollar limit to \$10,000 and removed the annual indexation methodology. Subsequent changes by the federal government reinstated the annual TFSA dollar limit back to the original \$5,000 and restored the indexation methodology. The reinstatement commences in 2016, meaning for 2015, all eligible individuals have access to the fixed \$10,000 in the annual TFSA dollar limit.

#### Example

Sylvester could afford to contribute only \$2,000 in 2012, \$1,500 in 2013 and \$3,000 in 2014. Therefore, his 2017 TFSA contribution room will be \$45,500 (\$5,000 carried forward for each year from 2009 to 2011, \$3,000 carried forward from 2012, \$4,000 carried forward from 2013, \$2,500 carried from 2014, \$10,000 carried from 2015, \$5,500 carried from 2016 and \$5,500 as his annual entitlement for 2017).

#### Example

At the beginning of 2016, Michelle had \$7,000 in unused TFSA contribution room. In August 2016, she withdrew \$3,000 and made no other contributions/withdrawals that year. Michelle will therefore have \$15,500 (\$7,000 + \$3,000 + \$5,500) in available contribution room at the beginning of 2017.

### Unlimited carryforward

Contribution room is cumulative and is carried forward indefinitely to future years. For example, if an individual was 18 years of age or older in 2009, a resident in Canada for every year from 2009 to 2017 and never contributed to a TFSA, then he or she could contribute \$52,000 in 2017.

### Recovery of contribution room

Unlike the RRSP system, where contribution room is completely exhausted as it is used, any amounts withdrawn from a holder's TFSA in a particular year is automatically added to his or her 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 allows the holder to re-contribute an equivalent amount in a future year.

### TFSA contribution room

	2009-2012	2013-2014	2015	2016-2017
Annual dollar limit	\$5,000	\$5,500	\$10,000	\$5,500
Indexing (\$500 increments)	Yes	Yes	No	Yes

### Tax structure

#### Funding using after-tax money

Unlike RRSPs but similar to registered education savings plans (RESPs) and registered disability savings plans (RDSPs), contributions to a TFSA are made with 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 registered retirement income fund (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 a holder can do with those withdrawals. And remember, any withdrawals actually taken cause a dollar-for-dollar recovery of contribution room to be used in the future (beginning in the following calendar year).

Stage	RRSP	TFSA
Tax-free funding	Yes	No
Tax-free growth	Yes	Yes
Tax-free withdrawals	No	Yes

#### Investment options

A TFSA is allowed to invest in a similar broad list of qualified investments permitted for RRSPs, including stocks, bonds and mutual funds.

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## Example

At the end of 2015, Pavel had no unused TFSA contribution room. In January 2016, he contributed the full \$5,500 of his annual TFSA dollar limit for the year. In April, he withdrew \$2,000 and then re-contributed that amount in August. Pavel had to pay \$100 ( $\$2,000 \times 1\% \times 5$ ) for the months of August to December. Beginning in January 2017, the penalty tax no longer applies as the annual TFSA dollar limit for the year (\$5,500) will absorb the entire excess amount.

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In November 2016, the CRA expressed that it will be changing its position on the use of funds from outside of a registered plan to pay for a combined investment management fee related to both an investor's registered and non-registered accounts. An increase in the value of the registered plan could be deemed to fall under the punitive "advantage" rules. An update to the relevant income tax folio is expected in early 2017 and should provide a more detailed interpretation and explanation of the CRA's position. In the meantime, the CRA has stated that it will defer the application of its revised position until the beginning of 2018, in order to allow for a "buffer period" during which the investment industry will have an opportunity to adjust its payment practices.

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## Excess contributions

An individual is generally considered to have an excess TFSA contribution at any time in a year if the total of all TFSA contributions (less any qualifying portion of a withdrawal) he or she made in the year exceeds the total TFSA contribution room at the beginning of the year. If at any time in the year the individual is considered to have an excess TFSA contribution, the highest excess amount will be taxed at 1% per month until the amount in excess is removed from the TFSA or the excess amount is absorbed by additional unused contribution room in a future year. Further, unlike RRSPs, there is no \$2,000 buffer. For any year the holder is subject to the penalty tax, he or she is required to complete and file CRA forms RC243, *Tax-Free Savings Account (TFSA) Return* and RC243-SCH-A, *Schedule A - Excess TFSA Amounts* by June 30 of the following year.

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## Advantage tax, prohibited investment and non-qualified investment rules

In an effort to limit illegitimate uses of the TFSA, the government introduced several anti-avoidance rules aimed at curtailing tax-planning schemes. Namely, the government enacted the advantage rules, the prohibited investment rules and the non-qualified investment rules. The rules impose a special penalty tax equal to 100% of the fair market value of the advantage obtained through the use of the TFSA and a 50% special tax on the fair market value of any non-qualified or prohibited investments acquired. Any income generated on a prohibited investment is treated as an advantage (for transactions after October 16, 2009), whereas any income generated on a non-qualified investment remains taxable to the TFSA. Generally, the effective date of these provisions applies after 2008. For a thorough discussion of these provisions and related rules, a tax accountant may be consulted.

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## Death

A primary beneficiary designation may be made directly on a plan (except in Quebec) to flow the proceeds (equal to the fair market value of the TFSA on the date of death) tax-free to a beneficiary. Any income or gains accruing in the TFSA after death are taxable to the beneficiary. If there is no beneficiary, the fair market value of the TFSA on the date of death is paid tax-free to the estate, and any income or gains accruing in the estate after the date of death is taxable to the estate.

Where a spouse or common-law partner is named primary beneficiary, it is possible for the spouse or common-law partner to transfer the proceeds to his or her own TFSA and designate the transfer as an "exempt contribution." The amount that can be designated is generally limited to the fair market value of the deceased's TFSA on the date of death. An exempt contribution does not affect the spouse or common-law partner's own TFSA contribution room. Any income or gains accruing in the TFSA after death are taxable to the spouse or common-law partner.

For a spouse or common-law partner, an alternative to the primary beneficiary designation is to designate that person as a successor holder, allowing the continuance of the existing TFSA or a transfer 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.

For more information, please see our *Tax & Estate InfoPages* titled *Death and taxes* and *Probate planning to minimize estate costs*.

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## Non-residents

A holder can contribute to a TFSA up until the date he or she is considered a non-resident of Canada and the annual TFSA dollar limit for the year is not pro-rated. If the holder becomes a non-resident, he or she can still hold the TFSA and continue to benefit from the tax exemption on investment income and withdrawals in Canada, but no TFSA contribution room will continue to accrue. However, any withdrawals made will automatically be added to the TFSA contribution room for the following year (and carried forward indefinitely). Any contributions made during non-residency are subject to a 1% penalty tax per month for each month these funds remain in the account. For any year the holder is subject to the penalty tax, he or she is required to complete and file CRA forms RC243, *Tax-Free Savings Account (TFSA) Return* and RC243-SCH-B, *Schedule B - Non-Resident Contributions to a Tax-Free Savings Account (TFSA)* by June 30 of the following year. This tax is in addition to the 1% penalty tax on excess contributions that may also be applicable.

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## Strategic use of TFSAs

### As loan collateral

Unlike RRSPs, which cannot be used as collateral for a loan (otherwise the RRSP is 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 common-law partner, the income attribution rules 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.

### Breakdown of marriage or common-law partnership

On the dissolution of a marriage or a common-law partnership, any TFSA amount may be transferred from the TFSA of one spouse or common-law 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.

### No maturity

Whereas an annuitant is required to convert his or her RRSP to a RRIF, annuitize the RRSP or bring the entire value of the RRSP into income in the year he or she turns 71, there is no maturity date for a TFSA. A holder can continue to contribute to a TFSA until his or her date of death (i.e., beyond age 71) and is not required to withdraw any amount.

### Interest deductibility

Since the income earned inside a TFSA (along with TFSA withdrawals) is non-taxable, a holder is not able to write off any interest expense on funds borrowed for the purpose of investing in a TFSA.

### Effect on income-tested government benefits

A significant drawback to receiving RRSP-sourced income is that the annuitant is not only taxed on that income but also 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 Benefit, and Goods and Services Tax/Harmonized Sales Tax Credit). In stark contrast, TFSA withdrawals are not income and, therefore, do not contribute to the loss of those income sources or tax credits.

### TFSA vs. RRSPs

While the plans are meant to be tax-neutral, where an individual has the same marginal tax rate (MTR) 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 the individual's tax rate upon original contribution. Conversely, TFSAs will work out better if the tax rate (including the effect of RRSP withdrawals on reduced income-tested benefits) will be higher upon ultimate withdrawal than it was when the individual contributed.

### TFSA compared with RRSPs at a constant MTR

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



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