

Taking Advantage of the TFSA

Adam Salahudeen L.L.B - Senior Manager, Taxation Advisory Services

As of January 2009, Canadians will be able to contribute up to \$5,000 to a Tax-Free Savings Account (TFSA) annually. Investment income earned within the account is earned tax free, regardless of whether it is interest, dividends or capital gains income. It is even a non-taxable event when funds are withdrawn from the account. As a result, the TFSA is widely seen as a welcome addition to an all-too-short list of bona fide Canadian tax shelters.

TFSA's are likely to play a significant role in the savings plans of Canadian residents 18 years of age and older, and are designed to help them save for ongoing financial goals such as automobile purchases, vacations or home renovations, including saving for a down payment on a home or additional top up funding for a child's education needs.

The TFSA is a very flexible investment vehicle that has numerous applications for all investing Canadians, ranging from young to retirement aged individuals as well as low income earners to high income earners.

For example, the TFSA is an attractive investment option for low income seniors because of the fact that tax-free withdrawals will not trigger reductions relating to income tested benefits such as Old Age Security or the Guaranteed Income Supplement. Moreover, there is no age limit for contributing to a TFSA thus retired seniors can take advantage of this added tax benefit throughout their entire lifetime.

Conversely, high-income investors may also wish to take advantage of the TFSA and shelter interest income or foreign dividends which are taxed at the top marginal tax rate.

The TFSA (unlike an RRSP) has no up front tax deduction, but this is balanced with the fact proceeds are not taxed when the money is withdrawn. Thus interest income, capital gains or dividends (generated by securities) will compound tax-free. Simply put, any funds withdrawn from the plan are available tax-free, and that withdrawal frees up and allows a comparable amount of new and future contribution room.

The following list illuminates some points of consideration and benefits of the Tax-Free Savings Account (TFSA):

1. Starting in January 2009, any individual (other than a trust) who is resident in Canada and 18 years of age or older (with a valid social insurance number 'SIN') will be eligible to establish a TFSA and save up to a maximum of \$5,000 each year. Note that contributions in excess of the \$5,000 maximum per year will be subject to a penalty tax of one percent per month. The \$5,000 contribution room will be adjusted and indexed for inflation in future years.
2. Contributions to TFSA will not be deductible for income tax purposes, however investment income, including capital gains, earned in a TFSA will not be taxed.



3. A TFSA will generally be permitted to hold the same investments as an RRSP, however a TFSA will be prohibited from holding investments in any entities with which the account holder does not deal at arm's length (i.e. specified shareholders of a private corporation with a 10% or greater interest).
4. An individual will be permitted to hold more than one TFSA at any given time. However all TFSA accounts are still subject to the single umbrella \$5,000 contribution amount. Any unused contribution room can be carried forward to future years, and there will be no limit on the number of years that unused contribution room can be carried forward.
5. An individual can withdraw from the TFSA at any time and for any purpose without penalty or tax. Any amounts withdrawn from an individual's TFSA in a year will be added to the individual's contribution room for the following year.
6. Neither income earned in the TFSA nor withdrawals will affect an individual's eligibility for federal income-tested benefits or credits such as the Canada Child Tax Credit, the Goods and Services Tax Credit and the Age Tax Credit. Nor will such amounts be taken into account in determining other benefits that are based on the individual's income level such as OAS, the Guaranteed Income Supplement or Employment Insurance benefits.
7. On the breakdown of marriage or a common-law partnership, an amount may be transferred tax-free between spouses or common-law partners without affecting the transferee's TFSA room. That is, the amount of the transfer will not reduce the receiving spouse's eligible contribution room, because this transfer will not be considered as a withdrawal, and therefore the transferred amount will not be added back to the transferor's contribution room at the beginning of the following year.

Planning Opportunities for the TFSA:

Combine RRSP's & TFSA for planning purposes:

A TFSA is widely seen as a more flexible investment vehicle than an RRSP. However, given the smaller contribution amount of \$5000, the TFSA should be used as complementary savings vehicle alongside the RRSP. The addition of the TFSA to an investor's financial plan can be used for building additional and supplementary retirement income while supplying a cash flow that's tax free.

Estate Planning:

Generally an individual's TFSA will lose its tax exempt status upon the death of the individual; however an individual will be permitted to name his or her spouse or common-law partner (CLP) as the successor account holder without losing the tax exempt status. TFSA assets can be transferred to a spouse/CLP upon death regardless of whether the surviving spouse/CLP has available contribution room, and without reducing the survivor's existing contribution room.



Note that provincial law governs beneficiary designations and at the time of this writing, only the following provinces have amended their legislation to now allow the designation of beneficiaries and successor holders for TFSAs: PEI, New Brunswick, Alberta and British Columbia. Furthermore, Manitoba and Nova Scotia currently have also tabled legislation, which should pass or be proclaimed shortly (contact your advisor for further updates). The remaining Provinces have not yet amended their laws to cover TFSAs. Consequently, for those provinces, beneficiary designations must be made through a Will (or in Quebec, through a Will or a marriage contract) as the beneficiary designation cannot be made directly through the plan (until it has been amended in that particular province).

Non-Resident Status:

If you were to emigrate from Canada and become a non-resident you can still hold your TFSA and benefit from the tax free status on investment income and withdrawals. However, no additional yearly contributions will be permitted once you become a non-resident (there are tax consequences if you continue to contribute) furthermore, the yearly contribution room of the TFSA will not continue to accrue by virtue of your non-resident status. Note that the jurisdiction to which you may have immigrated to may not recognize the tax free status of this account and the withdrawal may become a taxable event in that jurisdiction.

Interest Deductibility:

Interest on money borrowed to invest in a TFSA will not be deductible in computing income for tax purposes. One can however (unlike an RRSP) use their TFSA assets as collateral for a loan.

Income Splitting Opportunities:

A more interesting feature of the TFSA is the income splitting opportunity it affords to single income earning families. Attribution rules (specific tax rules that normally disallow income splitting among family members) do not apply to the TFSA, and as a result, the TFSA can now be used to allow a higher-income spouse to split income by contributing to the TFSA of the lower-income or stay-at-home spouse or adult child.

As noted above, the TFSA is a very significant addition to our savings system in Canada and represents a welcome change to how we invest and save. Take the time now to consider using as part of your overall savings and investment strategy. Contact your advisor today to explore the opportunities and potential impact that the TFSA may have on your financial plan.

The commentary and/or information provided herein should not be construed as legal or tax advice. Clients are strongly encouraged to seek the expertise of independent professionals, such as tax, legal and accounting experts prior to the final implementation of any strategy. Only after a diligent analysis of the client's needs, objectives and financial circumstances, including the client's financial position and tolerance for risk can an appropriate recommendation be made.

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