Tax planning with TFSAs

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Tax-Free Savings Accounts (TFSAs) became available to Canadians beginning in 2009. According to the government, the TFSA is a “flexible, registered general-purpose savings vehicle that allows Canadians to earn tax-free investment income to more easily meet lifetime savings needs.”

The basics

Any Canadian resident who is at least 18 years old can open a TFSA. The only requirement is that they must have a social insurance number when the account is opened. There is no limit to the number of TFSAs you can set up.

That being said, the total amount you can contribute to your TFSAs is based on your TFSA contribution room. While you are at least 18 years old and a Canadian resident, you accumulate TFSA contribution room each year, since 2009. This TFSA contribution room adds up and unused room is carried forward indefinitely to future years.

If you were 18 and have resided in Canada since at least 2009 and have never contributed to a TFSA, in 2021 you could contribute a total of $75,500. This includes $5,000 of TFSA contribution room for 2009 to 2012, $5,500 for 2013 and 2014, $10,000 for 2015, $5,500 for 2016 to 2018 and $6,000 for 2019 to 2021.

Any amounts withdrawn from your TFSA in a particular year will be automatically added to your TFSA contribution room for the following year. This means you can withdraw TFSA funds and re-contribute an equivalent amount. When you withdraw, you may need to wait until a future year to re-contribute to avoid penalties. Withdrawals made to correct over-contributions are not added back into contribution room.

Consider, for example, Julie, who maximized her TFSA contributions in prior years and also made the maximum contribution for the current year in June leaving her with no unused TFSA contribution room. She withdrew $10,000 in August to pay for her wedding reception. One month later, she took $10,000 from her wedding gift money and re-contributed it to her TFSA. Julie didn’t realize, but she put herself in an over-contribution position since the $10,000 withdrawal does not create further room until the following year.

The contribution and withdrawal rules also appear to have caused problems for some people who transferred their TFSA funds between financial institutions. Funds can be transferred directly from one of your TFSA plans to another TFSA plan without affecting TFSA contribution room. For a direct transfer, the proper form must be completed and submitted to the receiving financial institution, which will then arrange for transfer of the plan balance directly from the other financial institution. Many individuals who used the withdrawal/contribution method instead of the direct transfer method (for example, to avoid paying a transfer fee or waiting the typical turnaround time to complete the transfer) have found that they inadvertently went over their TFSA contribution limits.

Over-contributions, even if made innocently, can yield significant penalties. The penalty for making a "non-deliberate" over-contribution is 1% per month for each month the over-contribution remains in the TFSA. Deliberate over-contributions (where taxpayers clearly attempt to put in more than their limits to take advantage of tax-free income or growth) are also subject to a penalty of 100% of any income or gains resulting from the over-contribution; however, this 100% penalty is reduced by any amounts payable as a result of the 1% per month penalty applied on the same over-contribution for the same year.

Contributions "in kind" will result in a deemed disposition, with a capital gain being reportable and any capital loss denied, just as with in-kind RRSP contributions.

Unlike RRSPs, but similar to Registered Education Savings Plans (RESPs), contributions to a TFSA are made from after-tax funds (hence "tax pre-paid") and therefore will not be tax deductible from income. The big advantage, assuming you are not in an over-contribution position, is that any income and gains on investments held within a TFSA won't be taxed either while inside the TFSA or upon ultimate withdrawal.

This provides us with a number of specific planning opportunities.

Developing a savings plan

Many investors feel that it's prudent to maintain a "rainy day fund," a colloquial term used to describe funds that have been set aside in either cash or near-cash equivalents and that may be drawn upon in the event of that proverbial rainy day.

The philosophy behind a rainy day fund is that there should be an easily accessible source of money in the event something happens that requires a large, immediate and unexpected cash outlay, for example, to repair a leaky roof (perhaps the true source of the term).

However, cash or near-cash in such a fund is generally invested in highly-taxed, interest-bearing, fixed-income investments.

But if your emergency fund is in a TFSA, assuming you follow the rules, all interest income earned, either on a high-interest savings TFSA or a money market mutual fund TFSA, will be tax-free.

This all-purpose fund can also be used for non-emergencies and accessed multiple times during one's lifetime for various reasons, such as to buy a car, pay for a wedding, buy a home, etc.

Tax planning: TFSA or an RRSP?

One of the most common questions is: If you have limited funds, how do you choose between contributing to a TFSA or an RRSP?

The two plans are meant to be tax-neutral when marginal tax rates are constant. Figure 1 compares the after-tax accumulation over 20 years of $5,000 of employment or business income earned by an individual, invested through a TFSA or an RRSP.

In the TFSA scenario, the $5,000 is taxed upfront, when earned, at the individual's marginal tax rate (assumed to be 40%) and the after-tax amount of $3,000 is invested in the TFSA. Since this tax is literally "pre-paid" and since the earnings and growth inside the TFSA are not taxed during the accumulation phase, nor are they taxed upon withdrawal, the after-tax value after 20 years, assuming a 5% growth rate, is $7,960.

In comparison, take the example of $5,000 of income that you don't pay tax on immediately because it is put into your RRSP and a deduction is claimed for it. The $5,000 invested grows to $13,266 and is ultimately taxed upon withdrawal in 20 years at 40%. You net exactly the same amount after-tax, or $7,960.

Figure 1

Description	TFSA	RRSP
Pre-tax income	$5,000	$5,000
Tax (40%)	(2,000)	n/a
Net Contribution	$3,000	$5,000
Amount in 20 yrs, with 5% growth	7,960	13,266
Tax upon withdrawal (40%)	0	(5,306)
Net cash	**$7,960**	**$7,960**

While it appears that the two plans produce the same results, this only holds true if your upfront tax rate is the same as your tax rate later on.

RRSPs may make more sense when the tax rate upon withdrawal is expected to be lower than the tax rate upon original contribution. Conversely, TFSAs may mean you pay less tax overall, if your tax rate (including the effect of RRSP withdrawals on benefits such as the Guaranteed Income Supplement or Old Age Security, which are clawed back based on income as discussed below) will be higher upon withdrawal than it was when you contributed.

But the math doesn't tell the full story, since TFSAs are much more flexible. For example, the savings withdrawn can be re-contributed back into the TFSA later on. This can't be done with RRSPs.

Savings planning for all Canadians

A 2003 C.D. Howe study, called New Poverty Traps: Means-Testing and Modest-Income Seniors, concluded that "for many lower-income Canadians, RRSPs are a terrible investment." That's because many government benefits, credits and programs are based on net income and are substantially or even totally reduced as your income gets higher.

Canadians with low and modest income who receive the GST/HST Credit may find that even a small amount of taxable investment income can begin to reduce their credit. By earning all income tax-free inside a TFSA, the credit may be preserved.

Similarly, parents who receive the Canada Child Benefit (including the Child Disability Benefit) may find that taxable investment income reduces the amount of benefits to which they're entitled. Earning such income inside a TFSA should help to preserve some of the otherwise reduced benefits.

For seniors living on RRSP or Registered Retirement Income Fund (RRIF) withdrawals, one of the biggest criticisms of the current system is that when they withdraw funds upon retirement, not only are they taxed at the retiree's personal marginal tax rate but, in many cases, they affect the retiree's eligibility for federal income-tested government benefits and credits, such as the Age Credit, the Guaranteed Income Supplement (GIS) or even Old Age Security (OAS) benefits.

Since withdrawals from the TFSA are not considered to be "income," they don't affect the GIS or OAS nor will they reduce the Age Credit.

Additional information on saving using a TFSA versus an RRSP can be found in The RRSP, the TFSA and the Mortgage: Making the best choice.[1]

[1] The report, The RRSP, the TFSA and the Mortgage is available online at https://cibc.com/content/dam/personal_banking/advice_centre/tax-savings/rrsp-tfsa-mortgage-en.pdf.

Retirement planning

TFSAs can also help people who can't contribute to an RRSP for various reasons.

For example, employees who are members of registered pension plans through their employers may find their ability to contribute to an RRSP severely limited by the pension adjustment.

Similarly, Canadians who don't have any earned income or who are over 71 may find the TFSA a useful way to sock away extra funds for savings or retirement on a tax-free basis.

Education planning: TFSAs or RESPs?

While the RESP may be the ideal vehicle for most parents who wish to save money for their kids' post-secondary education due to the generous federal or provincial incentive grant and bond programs, they are not the only option.

A TFSA allows a parent to save not only to fund their children's post-secondary education but also for private, primary or secondary school education. In addition, when the earnings on the funds invested in the TFSA are withdrawn to fund the children's education, they come out completely tax-free.

Compare that to RESP income withdrawals, which generally come out in the form of fully taxable Educational Assistance Payments (EAPs). While EAPs are taxable to the student, if the student has a part-time job or works during the summer, chances are there may be some tax arising on the EAPs, whereas the TFSA withdrawals can be made by a parent tax-free and then given to the student to fund education expenses.

Income splitting with spouse or common-law partner and kids (over 18)

Normally, the attribution rules in the Income Tax Act block attempts at splitting either income or capital gains between spouses or partners[2] by attributing such income or gains back to the original spouse or partner.

The TFSA rules provide a specific exception to the attribution rules, so that the rules will not apply to any income or gains earned in a TFSA from a spouse or partner's gift to the TFSA holder that the TFSA holder contributes to their own TFSA.

This provides an opportunity for a high income spouse or partner to give an amount up to the annual contribution limit, to a lower income or zero income spouse or partner to contribute to their own TFSA.

Also, if you've got kids who are at least 18 years of age, you can consider giving them an amount up to their contribution limit annually to contribute to their own TFSAs. (You cannot set up a TFSA jointly or "in trust" for a child.)

Estate planning

The fair market value of the TFSA on the date of death will be received by the estate on a tax-free basis, but any income or gains accruing after the date of death will generally be taxable.

In most provinces, individuals are able to designate a surviving spouse or partner as a "successor holder," [3] in which case the TFSA will continue to be tax exempt. If a surviving spouse or partner is not validly designated as successor holder but acquires proceeds of the TFSA as a consequence of the deceased holder's death, called a "survivor payment," the lesser of the survivor payment and the date of death value of the assets of a deceased individual's TFSA can be transferred to the surviving spouse or partner's TFSA without affecting TFSA contribution room. The survivor must make the transfer before the end of the year following the year of death of the deceased. Also, within 30 days of the contribution, the survivor must file a special election with

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2 In this article, spouse refers to someone to whom you are legally married. Partner refers to a common-law partner under the Income Tax Act, which means someone who cohabits with you in a conjugal relationship, provided the two of you have cohabited for the past 12 months or are jointly parents of a child.

3 In Quebec, non-life insurance TFSA assets must first pass into the control of the liquidator of the deceased holder's estate. Therefore, it is not possible to make a surviving spouse or partner a successor holder on a non-life insurance TFSA. No exception to this has been made under Quebec legislation.

the Canada Revenue Agency using Form RC240, Designation of an Exempt Contribution Tax-Free Savings Account.

Alternatively, where permitted, you can also choose to designate a beneficiary of the TFSA who is not your spouse or partner. Doing so may have the benefit of allowing the proceeds from the TFSA to bypass the estate and flow directly to the named beneficiary, avoiding probate taxes where provincially applicable. Any increase in value of the TFSA after death would be taxed to the beneficiary.

Emigration (non-resident) planning

If you emigrate from Canada and become a non-resident, you can still hold a TFSA and continue to benefit from the tax exemption on investment income and withdrawals, however, no contributions will be permitted (without penalty taxes arising) nor will TFSA contribution room continue to accrue. Withdrawals made from a TFSA while not a resident are added back to an individual's TFSA limit and can be re-contributed if and when the individual re-establishes residency in Canada.

Keep in mind, however, that the other country won't necessarily recognize the tax-free status of the TFSA and therefore, will likely tax the account in accordance with its normal rules for investment accounts.

As with all planning strategies, seek the advice of a qualified financial planner or tax advisor to discuss how a TFSA could complement your existing saving and investment plans.

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