

TAX TALK

THE TAX-FREE SAVINGS ACCOUNT

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The 2008 federal budget introduced the **Tax-Free Savings Account** (TFSA) for individuals beginning in 2009. The TFSA allows you to set money aside without paying tax on the income and gains earned in the account. By investing in a TFSA, you can actually save faster for important goals such as retirement, small businesses, a new car or a family vacation because no tax is payable on any income in the account. You can withdraw funds at any time and for any purpose without incurring any tax liability.

Beginning January 2009, Canadian residents age 18 and older, who have a social insurance number, can contribute up to \$5,000 a year to a TFSA. All of the major financial institutions in Canada offer TFSAs as one of their products.

Contributions and Contribution Room

For 2009, the maximum contribution is \$5,000 with potential contribution limit increases in subsequent years subject to inflation¹. The contribution limits are not affected by income. Any unused TFSA contribution room may be carried forward indefinitely. Contributions to a TFSA are not deductible for tax purposes.

Unlike RRSPs, contributions to a TFSA can be made after age 71, which provides for additional opportunities to shelter investment income from tax.

Your TFSA contribution is not related to your RRSP contribution and, therefore, does not impact on your annual RRSP contribution limit. You can hold more than one TFSA (however your contribution limit does not change regardless of the number of accounts you hold).

Contributions to your spouse's TFSA will not affect the contribution room of your own TFSA. The attribution rules do not apply to funds you gift to your spouse to invest in a TFSA, which makes the TFSA ideal to split income with a lower-earning spouse, common-law partner or adult child.

Assets other than cash can be contributed to a TFSA, however there will be a deemed disposition for tax purposes at the time of the "in-kind" contribution. 50% of any capital gain realized on such a deemed disposition is taxable; however any capital loss so realized will be denied. Therefore, investments with accrued losses may be better held in other types of investment accounts.

Similar to RRSP over-contributions, there will be an over-contribution penalty of 1% per month, on any excess TFSA contribution amount.

If you become a non-resident of Canada, you can keep your TFSA, and the income earned in the TFSA or withdrawn from the TFSA will continue to be tax-free for Canadian tax purposes. As a non-resident you cannot contribute to a TFSA nor will you accrue any TFSA contribution room. Any contribution made to a TFSA by a non-resident is subject to a 1% per month tax until the contribution is withdrawn from the plan, or Canadian residency is resumed.

The Canada Revenue Agency (CRA) will track your contributions and contribution room available or carried forward. However, in order to obtain all this information, you will need to file a tax return, even if you have no tax payable. Similar to the RRSP, the contribution(s) and room carried forward will be shown on each taxation year's *Notice of Assessment*.

You do not need to have opened a TFSA account in order to accumulate contribution room. The accumulation of the contribution room will start at the eligible TFSA age of 18 years old. Someone who cannot open a TFSA account at 18 because the age of majority in their province of residence is 19 and older will accumulate the contribution room carried forward from the time they turn 18 years of age.

¹ The index to inflation will be in \$500 increments starting in 2010, however, at the current low inflation rate the \$5,000 annual limit is not expected to increase in the next few years.

Borrowing to Invest in a TFSA

Similar to an RRSP, interest on money borrowed and fees incurred to invest in a TFSA are not tax deductible. However, unlike an RRSP, the TFSA may be used as collateral for a loan.

Qualified Investments

Most RRSP eligible investments such as cash deposits, GICs, mutual funds, stocks and bonds are eligible TFSA investments. However, TFSAs are specifically prohibited from investing in certain types of investments.

Subject to certain restrictions, your TFSA can invest in shares of **private companies**. The company must meet the definition of a **“specified small business corporation”**. This means that, in general, the company must be a Canadian controlled private corporation that carries on an active business in Canada.

Prohibited Investments

Prohibited investments for a TFSA include:

- loans to the TFSA holder
- shares or debt of “non-arms length” entities, meaning any company in which you, your spouse and any other related persons, either individually or collectively own 10% or more of the shares.

A penalty tax will apply either where a TFSA acquires or where an investment held in the TFSA becomes a non-qualified or a prohibited investment. The penalty is 50% of the fair market value of the property at the earlier of the time it was acquired or the time it became such². In addition to this fair market value based penalty, an additional tax of 1.5 times the top individual income tax rate is payable on any income earned on investments which are prohibited. Capital gains and capital dividends would be fully taxable.

Withdrawals

You can withdraw funds at any time and for any purpose without incurring any tax liability. The amount you withdraw from your TFSA will be added to your unused contribution room and may be re-contributed back to the TFSA in a subsequent year.

To illustrate, if your TFSA invests a \$5,000 contribution in the stock market and the investment appreciates in value and is ultimately sold for \$15,000, you could sell

the shares and realize a tax-free gain of \$10,000; then, if you withdraw the \$15,000 of proceeds, you could later re-contribute \$15,000 to the TFSA, together with any unused TFSA contribution room.

Consequently, your contribution to a TFSA could be significantly higher than \$5,000 per year.

The funds withdrawn from the TFSA will not affect your eligibility for income tested benefits such as Old Age Supplement, Canada Child Tax Benefit or Guaranteed Income Supplement. Withdrawals also do not affect the income tested credits such as the GST/HST tax credit or age exemption credit.

RRSP vs. TFSA

Deciding whether contributions to an RRSP are better than contributions to a TFSA largely depends on two variables - the tax rate at which the contributions are made, and the tax rate at which withdrawals are taxed. When the two tax rates are identical, the TFSA is the better option because it is more flexible and withdrawals do not affect income-tested benefits, i.e. Old Age Security repayments.

Taxpayers who are currently taxed at a low rate generally prefer the TFSA to the RRSP in order to preserve and carry forward their RRSP contribution room (deduct RRSP to save more tax in a year when you are taxed at a higher marginal tax rate).

If you expect your marginal tax rate to be lower in retirement than it is now, RRSPs are preferred. Your RRSP contribution will generate both a tax deferral and a tax saving. However, if you expect your effective marginal tax rate to be higher in your retirement years than in the contribution years, the TFSA is the better option. Withdrawals from TFSAs are not taxable and do not impact income tested benefits and credits.

² The tax may be refunded if the non-qualifying or prohibited investment was not deliberate and if the TFSA disposes of the offending investment by the end of the year following the year in which the investment was made/became non-qualifying or prohibited.

The following chart provides a comparison between an RRSP investment and a TFSA investment:

	TFSA	RRSP	Regular Savings
Pre-tax income	\$1,000	\$1,000	\$1,000
Tax (if 40% rate)	400	0	400
Net contribution	600	1,000	600
Investment income (if 20 years at 5.5%)	1,151	1,918	707
Gross proceeds (net contribution plus investment income)	1,751	2,918	1,307
Tax (40% rate)	0	1,167	0
Net proceeds	1,751	1,751	1,307
Net annual after-tax rate of return (%)	5.5	5.5	4.0

As illustrated in the chart, the significant concerns will be the marginal tax rate of the individual contributor both in the year the contribution is made and in the year funds are withdrawn. Other considerations are: pension income splitting, the anticipated rate of return on the investment(s), as well as any possible capital gains (fully taxed if realized in RRSP, but not taxed if realized in TFSA).

Contributions to an RRSP may be more attractive if you are borrowing to make a contribution, given the RRSP contribution will generate a tax refund which can be used to reduce the amount borrowed or to invest in a TFSA.

It would be expected that taxpayers who can make high pre-tax contributions would rather use the RRSP as an investment vehicle, since they would then have access to a lower tax rate on withdrawals in retirement. But once the taxpayer has maxed out on the RRSP contribution, the TFSA provides an advantage for investing funds which will earn tax-free income. The taxpayer can also gift money to their spouse to contribute to a TFSA without affecting their own TFSA contribution room. Therefore, the TFSA provides an added benefit vis-a-vis the RRSP, especially for those individuals who have investment funds available but whose RRSP contributions are limited to their RRSP contribution room.

For those taxpayers who cannot afford to maximize both their RRSP and their TFSA contribution, the decision of how to split the investment between the two will depend on their specific circumstances and mainly on the analysis of their marginal and expected tax rates as discussed above.

For taxpayers receiving income tested benefits or credits, the TFSA will be preferred to the RRSP, since the TFSA income and withdrawals do not reduce their entitlement to tax incentives which are based on tested income, but the income from RRSP withdrawals will reduce their entitlement to such incentives.

Prior to the introduction of the TFSA, from a tax standpoint, it was better to hold equity shares that you expect to grow in value outside of your RRSP. Income earned in an RRSP will eventually be taxed as pension income at your full marginal income tax rate in the year that you withdraw funds. You only pay tax on 50% of your capital gains on property you hold *outside* your RRSP.

The RRSP was the preferred investment vehicle for holding investments earning interest and foreign dividends given these types of income would be taxed at your top marginal rate if earned outside your RRSP and will be taxed at your top marginal rate as pension income when you eventually withdraw funds. Now, given a choice, these types of investments should rather be held in a TFSA in order to save more tax.

TFSA vs. Mortgage

The TFSA versus mortgage payment decision depends on the implicit rate of return in the TFSA. Both the contribution to a TFSA and mortgage payments are made with after-tax dollars. If the earnings rate in your TFSA is higher than your after-tax mortgage interest rate, then it is generally better to invest in a TFSA rather than make additional mortgage payments. If the earnings rate in your TFSA is lower than your after-tax mortgage rate, it is generally better to pay down your mortgage.

For many, if the after-tax rates are similar, many will choose to pay down the mortgage first, especially since TFSA contribution room accumulates and should be available when the mortgage is paid off.

TFSA vs. RESP

When saving for a child's education, the RESP appears to be the better option for contributions that are eligible for the maximum CESG annual grant of \$500 (20% on \$2,500). Unlike the TFSA withdrawals, which will be tax-free, the withdrawals of RESP income and grant is taxable to the student recipient, however, students frequently pay little or no tax on the RESP withdrawals if their income is nominal.

In the year that the child turns 18, the CESG is no longer available and the TFSA becomes a more viable investment vehicle.

Other TFSA Matters

Capital losses realized in a TFSA cannot be applied against capital gains realized outside the TFSA. For this reason, stocks and mutual funds might be better held in a non-registered account so that any losses realized on their subsequent disposition could be used to offset other capital gains realized outside the TFSA.

The “tax-free” status of a TFSA is only for Canadian tax purposes. The income earned in a TFSA will be treated as ordinary investment income for US tax purposes for US citizens and green card holders living in Canada. Unlike income earned in various registered plans, which can be deferred³ for US tax purposes, income earned in a TFSA will be subject to US tax in the year earned, regardless of whether any funds are withdrawn from the TFSA.

Tax Implications on Death of Taxpayer

Your TFSA may be transferred to your surviving spouse or common law partner⁴ and still maintain its tax-free status or the TFSA assets can be contributed to your spouse’s or common-law partner’s plan upon your death without any impact on his/hers contribution room. TFSA contribution room, however, cannot be transferred to the surviving spouse.

Your spouse must be named as the “successor account” holder. Generally, any investment income earned in the TFSA after the holder’s death is no longer tax exempt unless the assets are passed on to a spouse’s TFSA within two years.

Foreign Withholding Tax

Under the Canadian *Income Tax Act* TFSAs can be structured as deposits, annuity contracts or trusts. TFSAs offered by brokerage firms will be generally structured as trusts and will offer a wide range of investment choices, including US and foreign securities.

A TFSA account is not an exempt account under the Canada-US Tax Convention since it is not a pension trust. Therefore, dividends earned on US securities will be

subject to US withholding tax at 15%⁵. As the TFSA income is not taxed in Canada, any foreign withholding tax on TFSA income cannot be refunded or claimed as a tax credit in Canada, and thus becomes a permanent cost of holding foreign investments in your TFSA.

Anti-Avoidance

Anti-avoidance provisions have been included in the *Income Tax Act*, and imposes a penalty when an “advantage” is conferred on the TFSA holder or a person related to the TFSA holder. This provision is meant to avoid the use of a TFSA in ways which were not intended by its introduction and which are non-commercial in substance. The penalty will be equal to the fair market value of the “advantage”.

An “advantage” is generally defined as any benefit that depends on the existence of the TFSA.

On October 16, 2009, the Minister of Finance proposed changes to the TFSA rules regarding the use of TFSAs in tax planning “schemes”. The proposed changes, to be effective October 16, 2009, would (i) subject any income earned on deliberate over-contributions and prohibited investments to the existing anti-avoidance rules, (ii) tax income earned on the TFSA on non-qualifying investments at the regular tax rates, (iii) ensure withdrawals of deliberate over-contributions, non-qualifying or prohibited investments and related income does not create additional TFSA contribution room and (iv) prohibit asset transfers between registered and non-registered accounts and a TFSA.

A memorandum of this nature cannot be all encompassing and is not intended to replace professional advice. Its purpose is to highlight tax-planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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³ Under the Canada-US Tax Convention, US persons living in Canada can elect to defer US tax on income earned each year in an RRSP, registered retirement income fund or a deferred profit sharing plan, until an actual distribution is made from the plan.

⁴ The spouse or common law partner must be named as the “succession holder” in the TFSA account. When the TFSA holder dies, the spouse becomes the new holder, keeping the tax exempt status.

⁵ Depending on the specific situation of the account and/or the account holder, the documentation requirements of the financial institutions will vary, US Tax documentation forms as W8 series or W9 forms may be required to benefit from this reduced withholding tax rate.