RBC Dominion Securities

THE ADVISOR

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Tax-Free Savings Account (TFSA)

How the TFSA can help you reach your financial goals

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The Tax-Free Savings Account (TFSA) was introduced by the Federal Government in the 2008 budget. Starting in 2009, you will be able to use this flexible savings vehicle to save for a variety of your short-term and long-term goals without any tax consequences. The TFSA will be available at RBC Dominion Securities in early 2009.

What is the Tax Free Savings Account?

The TFSA contains elements of both a registered and unregistered account. It allows Canadians to earn tax-free investment income and capital gains, which may help you reach your financial planning goals more quickly. It can also provide an additional source of tax-efficient savings and may complement existing registered savings plans including retirement savings plans (RSPs), retirement income funds (RIFs) and registered education savings plans (RESPs).

WHO CAN CONTRIBUTE TO A TFSA?

All Canadian residents aged 18 and older who have a social insurance number will be able to open a TFSA starting in 2009. If 18 is not the age of majority in the province where you live (currently 19 is the age of majority in Newfoundland and Labrador, New Brunswick, Nova Scotia, British Columbia, Northwest Territories and Yukon), you will be able to open a TFSA when you reach the age of majority in your province of residence. However, TFSA contribution room will still start to accumulate from age 18.

CAN I CONTRIBUTE TO MY SPOUSE OR CHILD'S TFSA?

If you gift money to your spouse or adult child to contribute to their TFSA, the income and growth in the account will not be subject to the attribution rules. This could help a lower income spouse or adult child who has little or no earned income to earn tax-free investment income and save for retirement as everyone receives annual contribution room, irrespective of their income.

CAN A NON-RESIDENT OF CANADA CONTRIBUTE TO A TFSA?

If you become a non-resident of Canada, you will not be able to make further contributions to your TFSA and you will not accrue further contribution room for any year throughout which you are a non-resident. However, you can retain your TFSA while you are living outside Canada and you will not be taxed in Canada on the income or capital gains earned in the account or on any withdrawals you make.

It is a good idea to obtain professional tax advice in the country where you are living to determine how the funds in your TFSA will be treated for tax purposes in that jurisdiction.

HOW MUCH CAN I CONTRIBUTE?

All eligible Canadian residents will be able to contribute $5,000 to their TFSA every year. This contribution room will be indexed to the rate of inflation and will increase in $500 increments.

If you do not use your contribution room in a particular year, you can carry the unused room forward throughout your lifetime to use in a future year. Your income level has no bearing on your contribution room. There is no lifetime limit on the amount you can contribute and no age limit that restricts your ability to continue making contributions.

Note that contributions to a TFSA cannot be deducted from your taxable income.

If you withdraw funds from your account, the amount of the withdrawal will be added to your unused contribution room and you can re-contribute it in any year following the year you made the withdrawal. This means that you can withdraw funds as needed and reinvest them in the account throughout your lifetime without losing contribution room.

TAX-FREE INVESTMENT INCOME AND WITHDRAWALS

You will not pay tax on the investment income and capital gains earned inside your TFSA and consequently, you cannot use losses generated in the account to offset other taxable capital gains outside the TFSA.

Another consequence of the tax-free status of TFSA investment income is that if you borrow funds to invest in the account, you will not be able to deduct the interest on those borrowed funds for income tax purposes. However, you can use the assets within your TFSA as collateral for a loan.

In addition, you can withdraw funds from the account at any time, for any reason, without including them in your taxable income. For this reason, funds accumulating in your TFSA will not have an impact on any income-tested benefits you may be receiving, such as Old Age Security and Employment Insurance, or your entitlement to the age tax credit.

HOW DOES A TFSA COMPARE TO AN RSP?

Here's a summary of the main differences between these two accounts:

- If you contribute funds to an RSP they are tax-deductible. Funds you contribute to a TFSA are not.

- There are maximum age restrictions on making contributions to an RSP. You can make contributions to a TFSA from age 18 onwards throughout your lifetime.

- The contribution room available in an RSP is determined according to your eligible earned income. For a TFSA, everyone accrues a defined amount of annual contribution room from age 18 onwards, irrespective of earned income.

- If you make withdrawals from your RSP, they are included in your income for the year in which you made the withdrawal. You will not pay tax on funds you withdraw from a TFSA.

- If you withdraw funds from an RSP you cannot recontribute them unless you generate more contribution room. This is not the case with the TFSA. When you make a withdrawal from your TFSA, the amount withdrawn is automatically added to your contribution room for the following year. You can recontribute funds you have withdrawn at any time after the year you made the withdrawal.

- Funds withdrawn from your RSP will increase your taxable income for the year of withdrawal and may have an impact on any income-tested benefits or tax credits you may be receiving. In comparison, if you withdraw funds from a TFSA, you are not taxed on them. This means that the withdrawal will not affect your eligibility for income-tested benefits and tax credits.

- You are not required to convert a TFSA to an income-stream at a certain age, as is the case with an RSP.

There are also similarities between a TFSA and an RSP:

- Funds invested in your TFSA will grow tax-free inside the account.

- The funds in your TFSA will be subject to similar investment restrictions as those that apply to an RSP.

- On your death, the funds in your TFSA can be transferred to your surviving spouse on a tax-deferred basis.

- You could pay a penalty tax of 1% per month on TFSA contributions that exceed your contribution room.

WHAT WILL HAPPEN TO MY TFSA IF I DIE?

The funds in your TFSA grow tax-free until the date of your death. After your death the earnings in the account will be taxable unless you name your spouse or common-law partner as the successor account holder. In this case the earnings in the account will continue to grow tax-free. The assets in the account could also be transferred to your spouse or common-law partner's TFSA without affecting their TFSA contribution room.

At present it appears that you will not be able to designate a beneficiary for your TFSA in the same way that you can for an RSP. You will only be able to pass your TFSA on to a beneficiary by naming that person in your Will. If you don't include such a clause in your Will, the funds in the TFSA will pass as part of the residue of your estate on your death.

FOR MORE INFORMATION

This summary is based on the information currently available about the new TFSA. For more details about this new account and how it can help you achieve your financial planning goals, speak to your advisor.