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Strategies to incorporate the Tax-Free Savings Account (TFSA) into your financial plan

Maximizing the benefits of the new TFSA

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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 tax-free throughout your lifetime. It is expected that the TFSA will be available at RBC Dominion Securities in early 2009.

This article is intended to introduce some potential financial planning strategies that may help you maximize the benefits of the TFSA. Depending on your stage of life and your financial priorities, you may be able to integrate this additional source of tax-free investment income into your overall financial plan.

Income-splitting opportunities

GIFTS TO A SPOUSE

If your family consists of a high-income spouse and a lower-income spouse, you may be able to benefit from some potential income-splitting opportunities using the TFSA.

When a higher-income spouse provides funds to their lower-income spouse to contribute to their TFSA, the lower-income account holder will not pay tax on the investment income and capital gains earned in the account. Consequently, unlike a non-registered account, the income attribution rules will not apply to the spouse who provided the funds. This helps achieve family income-splitting, plus, due to the account's tax-free status, there is no impact on any spousal tax credits that may be available to the higher-income spouse for the low-incomer spouse.

In contrast to conventional income-splitting strategies that consider the source of the invested funds, both spouses can earn tax-free investment income using the TFSA, regardless of which spouse contributed the funds. As the TFSA allows for full tax savings, compared to the tax savings available through conventional income-splitting strategies, there can be greater potential for investment growth as each spouse's contributions build over time.

It is also worth noting that a lower-income spouse who has little or no earned income with which to build RSP contribution room may still be able to accumulate some additional retirement savings using their annual TFSA contribution room. The TFSA contribution room will continue to accrue throughout their lifetime whether or not they have earned income because everyone gets the same contribution room.

GIFTS TO ADULT CHILDREN

You can use the TFSA in addition to a retirement education savings plan (RESP) as another tax-sheltered way to save for a child's education. By gifting funds to a child who is over the age of 18, they can contribute to a TFSA and they will not pay tax on the investment income they withdraw from the account as they would with RESP withdrawals. Note however that contributions to a TFSA will not attract the Canada Education Savings Grant.

Opportunities for Retirees

Retirees may be one of the major groups to benefit from the TFSA. Here's a summary of some of the potential opportunities:

- If you have stopped working but still have cash flow that is surplus to your needs, for example from investment income or an inheritance, you may wish to continue building your savings but no longer have earned income with which to generate RSP contribution room. The TFSA may provide a way to save in a tax-free environment for the future.
- You can contribute to this tax-free savings vehicle even after you turn 71 and are no longer able to contribute to your RSP. If you are receiving either the required annual minimum RIF income or pension income that is in excess of your current needs, then consider contributing the excess to your TFSA to preserve some tax-free growth. This may prove useful for your future needs without a requirement to convert it to an income vehicle at any time in the future.
- If you anticipate being in the same or a higher marginal tax bracket in retirement, a TFSA could provide another source of tax-efficient retirement income. Unlike withdrawing funds from a registered plan at a higher future tax rate, withdrawals from a TFSA are not taxable at all.

- Another advantage of using a TFSA to complement your existing sources of retirement income is that, as withdrawals from the account are not taxable income, they do not have an impact on any federal income-tested benefits and credits you may receive. This reduces the possibility of the Old Age Security (OAS) clawback, and will not limit your entitlement to Employment Insurance benefits, the Guaranteed Income Supplement, the Canada Child Tax benefit and the Age Credit as could be the case with withdrawals from non-registered plans.

The TFSA can complement your existing registered savings plans

Depending on your financial circumstances and your stage of life, you could use the TFSA to complement your existing registered savings plans:

- If you have RSP contribution room, consider making a contribution and using the tax refund you receive to contribute to a TFSA. This could be a way to save for various goals, for example, a home, a car or travel, while sheltering income from taxation.
- If you have maximized your RSP contributions based on your available contribution room or can no longer make RSP contributions due to your age, you could use your TFSA to earn additional tax-sheltered investment income. You can withdraw funds from the account when you need them and re-contribute them without tax consequences.
- You may wish to consider using your TFSA to accumulate funds in addition to an RESP. This could be another tax-sheltered way to save for a child's education. By using your own TFSA, you can start investing long before your child is 18 and able to open their own account, and the funds can be withdrawn tax-free when they are needed.
- If you are still building your wealth for the future, consider transferring $5,000 of non-registered assets to your TFSA every year. Note that this transfer could potentially trigger unrealized capital gains, which would result in an immediate tax liability. During your peak earning years when you are in a higher tax bracket, contributing to your RSP may make sense to give you the benefit of the income tax deduction. Then you could withdraw the funds when you are in a lower tax bracket, possibly in retirement, and contribute to a TFSA to generate tax-free investment income that you can access whenever you need it.
- If you are able to make contributions to your TFSA and are looking for an additional source of retirement income in future years, you may enjoy the flexibility of being able to withdraw funds from the account without tax consequences when you need them. Then in future years you can recontribute the funds you have withdrawn without losing your contribution room.

Create an emergency fund

You could use the TFSA to help create an emergency fund. As these funds may be needed urgently and have to hold their value, typically more secure, less volatile interest-earning securities are used. As interest in a non-registered account is not favourably taxed, the TFSA may be a great place to accumulate the two- to three-months salary often suggested for this type of fund. You could earn interest income on the funds tax-free and have access to them when you need them. Consider using your TFSA as a complement to a line of credit as another way to meet unexpected expenses.

If you are considering borrowing funds to invest in a TFSA as part of your overall financial plan, note that you will not be able to deduct the interest you pay on the borrowed funds. However, if you have short-term borrowing needs and don't want to withdraw funds from your TFSA, you can use the assets in your TFSA as collateral for a loan. Using your RSP as collateral like this is not permitted.

Summary

The TFSA can help you achieve greater flexibility in saving and investing throughout your lifetime. Though the TFSA may add to the overall complexity of your financial situation, it can also provide more sources of income to draw from in retirement. If you make the maximum contribution to your RSP every year, a TFSA can be a great complement even though the contribution doesn't provide a tax deduction.

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