



October 21, 2010

FINANCIAL ADVISORY SUPPORT

Tax-Free Savings Account (TFSA)

How the TFSA can help you reach your financial goals

The Tax-Free Savings Account (TFSA) was introduced by the federal government in the 2008 budget. Since January 1, 2009, you have been able to use this flexible savings vehicle to save for a variety of your short-term and long-term goals with the benefit of tax-free growth.

What is the Tax Free Savings Account?

The TFSA contains elements of both a registered and non-registered account. It allows you 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 Registered Retirement Savings Plans (RRSPs), Registered Retirement Income Funds (RRIFs) and Registered Education Savings Plans (RESPs).

There are three different types of TFSAs: a deposit, an annuity contract and a trust arrangement. If your TFSA is a trust arrangement, it can be self-directed. This allows you to develop and manage your own portfolio.

Who can contribute to a TFSA?

All Canadian resident individuals aged 18 and older who have a social insurance number have been able to open a TFSA since 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, Yukon and Nunavut), 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 start to accumulate from age 18. You do not have to set up a TFSA or file a tax return to earn contribution room.

Can I contribute to my spouse's or child's TFSA?

The account holder is the only person who can contribute to their own TFSA. However, 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 or other goals 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.

If you make a contribution while you are a non-resident, you will be subject to a 1% per-month tax for each month the contribution stays in the account. 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. Any withdrawals made while you are a non-resident will be added to your unused TFSA contribution room in the following year, but will be unavailable unless you re-establish Canadian residency for tax purposes.

You can contribute to a TFSA up to the date that you become a non-resident of Canada. The TFSA contribution limit is not pro-rated in the year of emigration or immigration.

If you become a non-resident of Canada, it is a good idea to obtain professional tax advice in the country where you will be resident 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 can contribute \$5,000 to their TFSA every year. This contribution room is indexed to the rate of inflation but will only 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 are not tax-deductible. In other words, contributions are made with after-tax funds.

If you withdraw funds from your TFSA, the amount of the withdrawal will be added to your contribution room for the following year, and you can re-contribute that amount starting January 1 of the following year. This means that you can withdraw funds as needed and reinvest them in the account throughout your lifetime without losing contribution room. The contribution room is not available in the same year as the withdrawal, and if any amount is re-contributed in the same year (assuming you do not have any other unused contribution room) it could result in an overcontribution and penalties.

Under proposed changes announced on October 16, 2009, certain withdrawals may not be added back to your contribution room for the following year. These include withdrawals of deliberate overcontributions, prohibited investments, non-qualified investments, amounts attributable to swap transactions and related income and capital gains on all of these items.

In addition, withdrawals of amounts considered an “advantage” and any related income and gains will not be added back to your TFSA contribution room in the following year. An advantage is very broadly defined, so you should speak to your professional tax advisor if you think any transaction is questionable.

Swap transactions previously mentioned generally mean any transfer of property occurring between the TFSA and the holder of the TFSA or a person with whom the holder does not deal at arm's length, other than a transfer that is a distribution from or a contribution to a TFSA. This means that effective October 17, 2009, you will not be able to swap securities between your TFSA and any of your registered or non-registered accounts. A swap transaction is considered an advantage and subject to tax consequences and reporting requirements.

Are investment income and withdrawals subject to tax?

Generally, you do not pay tax on investment income and capital gains earned inside your TFSA, and consequently, you cannot use losses generated in the account to offset other income outside the TFSA. However, if you have foreign investments in your TFSA, they may be subject to foreign withholding tax, which cannot be claimed as a foreign tax credit on your personal tax return.

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 will be able to use the assets within your TFSA as collateral for a loan.

You can withdraw funds from the account for any reason, at any time, although timing may depend on what you are invested in — for example non-redeemable GICs may not have matured. Withdrawals will not be included in your taxable income. For this reason, funds accumulating in your TFSA will not have an impact on any federal income-tested benefits you may be receiving, such as Old Age Security and Employment Insurance, or your entitlement to the age tax credit.

How are transfers treated?

Between TFSAs of the same individual

You can transfer funds directly from one of your TFSAs to another of your TFSAs without affecting your contribution room limit and without any tax consequences, but it must be done as a qualifying transfer. If you withdraw funds from one of your TFSAs and contribute those same funds to another of your TFSAs, the transactions will be treated as a withdrawal and a contribution, which will affect your contribution room limit, and you may be subject to tax on any excess contributions.

Marriage or common-law partnership breakdown

When there is a breakdown in your marriage or common-law partnership, it is possible for you to transfer an amount directly from your TFSA to your spouse's or common-law partner's TFSA without affecting either's contribution room. You and your current or former spouse or common-law partner must be living separate and apart at the time of the transfer, and the transfer must be made under a decree, order or judgment of a court, or under a written separation agreement to settle rights arising out of your relationship on or after the breakdown of your relationship.

The transfer must be made directly between the TFSAs to avoid any negative tax consequences.

Are there circumstances when taxes may be payable?

Overcontributions

If you contribute more than your TFSA contribution limit, you will be subject to a penalty tax of 1% of the highest excess TFSA amount in the month, for each month you are in an overcontribution position.

For any year in which you owe tax on an excess TFSA amount in your account, you are required to file a TFSA Return 20 (Form RC243) and Schedule A — Excess TFSA Amounts (Form RC243-SCH-A). The return must be filed and the taxes owing must be paid no later than June 30 following the calendar year for which the tax is payable.

Under proposed changes announced on October 16, 2009, for transactions after that date, any earnings and gains reasonably attributable to deliberate excess contributions will be considered an “advantage” and will be subject to a penalty tax. The penalty tax is calculated as the fair market value of the benefit, which in this case would be equal to 100% of the earnings or gains.

Non-qualified investments and prohibited investments

If a TFSA acquires property that is either a non-qualified investment or a prohibited investment, there are consequences in terms of reporting and tax payable by the TFSA trust as well as the holder of the TFSA. This also applies where property already in a TFSA becomes a non-qualified investment or a prohibited investment. The tax is equal to 50% of the fair market value of the property at the time it was acquired or it became non-qualified or prohibited.

If you are subject to this tax, you are required to file a TFSA Return 20 (Form RC243). This tax may be refundable unless it is reasonable to expect that you knew, or should have known, at the time the property was acquired that it was or would become a non-qualified investment or a prohibited investment.

Under proposed changes announced on October 16, 2009, for transactions after that date, the earnings or increase in value reasonably attributable to a prohibited investment are subject to tax at a rate of 100%. This means that the tax is equal to any income or gains earned on prohibited investments.

What will happen to my TFSA when I die?

The funds in your TFSA grow tax-free until the date of your death. On death, your TFSA is deemed to be disposed at its fair market value, although all income earned before your death remains tax-exempt, while income earned after your death is generally taxable to your beneficiaries (except in the case of a spouse or common-law partner in certain circumstances as discussed later). It is not possible for your executor to make a post-death contribution on your behalf to use up any unused TFSA contribution room.

The TFSA contract in most provinces permits you to designate either a “successor holder,” who can only be a spouse or common-law partner, or a “beneficiary,” who can be any person(s) including a minor child (although this may not be advisable). Further, many TFSA contracts may even allow you to designate both a successor holder and an alternate beneficiary or several beneficiaries, but the beneficiary designation would only take effect if the successor holder is deceased.

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The advantage of naming someone directly on your TFSA contract is that your TFSA property will bypass your Will on death, thereby avoiding probate tax (if applicable in your province of residence) and simplifying estate administration for your executor(s).

Before naming a minor child as your TFSA beneficiary, it is important to be aware that minors cannot receive an inheritance directly, which may require the involvement of the Children's Court and/or the Public Guardian and Trustee in your province.

If your spouse or common-law partner is named successor holder, they will simply step into your shoes as the new TFSA plan holder without affecting their unused TFSA contribution room. This involves a simple name change, and there will be no tax consequences to you or your spouse or common-law partner, with the exception of a potential 1% overcontribution penalty to your spouse or common-law partner if you have an excess amount in your TFSA at the time of your death and their own unused TFSA contribution room is insufficient to absorb it.

If your goal is to avoid probate tax and you wish to name someone other than your spouse or common-law partner, such as your adult or minor child, you may designate them as your beneficiary in the TFSA contract. Income earned until your date of death is tax-exempt, while income earned after your death must be reported on a T4A as "other income" and will be taxable to your beneficiary(ies) in the year it is received.

If there is neither a successor holder nor a beneficiary named in your TFSA contract, or if you name your estate as your TFSA beneficiary, your TFSA property will be subject to probate tax (if applicable in your province of residence) and distributed as per the terms of your Will.

If your spouse or common-law partner is your sole estate beneficiary or is named the beneficiary of your TFSA, then as the survivor of your TFSA, they will have the option of making a tax-exempt rollover of some or all of the fair market value of your TFSA, in addition to an "exempt period amount," into their TFSA without affecting their unused contribution room. The exempt period amount consists of property that cannot exceed the income earned during the exempt period, which commences the day after your death and ends on December 31 of the year following the year of death.

It is important to note that this rollover must be completed within this exempt period, and your survivor must file Form RC240 — Designation of an Exempt Contribution Tax-Free Savings Account (TFSA) within 30 days of the rollover contribution date to designate this contribution as a survivor payment. Otherwise, the tax implications will be no different than if you had designated a non-spouse or non-common-law partner, as income earned in your TFSA after your death will be taxable to your spouse or common-law partner, while income earned before your death will remain tax-exempt.

After the exempt period has passed, if still undistributed, your TFSA will become a taxable inter vivos trust requiring an annual T3 trust return. Any unpaid income earned after your death is taxable (at the highest personal tax rate) in the trust, unless it can be allocated to a beneficiary.

Finally, you may also name a registered charity as your beneficiary, resulting in a charitable donation tax credit on your final tax return for the fair market value of your TFSA on your date of death. The transfer of funds must generally occur within the 36-month period following your death.

How does a TFSA compare to an RRSP?

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

- If you contribute funds to an RRSP, they will be tax-deductible. Funds you contribute to a TFSA are not.
- There are maximum age restrictions on making contributions to an RRSP. If you are eligible, you can make contributions to a TFSA from age 18 onwards throughout your lifetime.
- The contribution room available in an RRSP 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 RRSP, they will be 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 RRSP, you cannot re-contribute them unless you generate more contribution room. This is not the case with a TFSA. When you make a withdrawal from your TFSA, the amount withdrawn will be automatically added to your contribution room for the following year. You can re-contribute funds you have withdrawn at any time after the year you made the withdrawal.
- Funds withdrawn from your RRSP 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 will not be taxed on them. This means that the withdrawal will not affect your eligibility for federal 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 RRSP.

There are also similarities between a TFSA and an RRSP:

- Funds invested in your TFSA will grow tax-free inside the account.
- Generally, the types of investments that are allowed in a TFSA are the same as those allowed in an RRSP.
- 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.

For more information

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



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