RBC Dominion Securities

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Tax-Free Savings Account (TFSA)

How the TFSA can help you reach your financial goals

Financial Advisory Support

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 Royal Bank in 2009.

What is the Tax Free Savings Account?

The TFSA contains elements of both a registered and non-registered 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, 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 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.

You can withdraw funds from the account for any reason, at any time, although timing may depend on what you 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 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. If you are eligible, 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. On death, your TFSA is deemed to be disposed at its fair market value although all income earned before your death will remain tax-exempt, while income earned after your death is generally taxable to your beneficiaries. 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 could be any person(s) including a minor child. Further, many TFSA contracts may even allow you to designate both, a 'successor holder' and an alternate 'beneficiary' or several beneficiaries. The advantage of naming someone directly on your TFSA contract is that your TFSA property bypasses your Will on death, thereby avoiding probate tax 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 would require the involvement of the Public Guardian and Trustee.

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 are no tax consequences to you or to your spouse or common-law partner with the exception of a potential 1% over-contribution 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 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 will be reported on a T4A as "other income" and taxable to your beneficiary (ies) in the year it is received.

If there is neither a 'successor holder' or '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 and it will be distributed as per the terms of your Will. For example, if your spouse or common-law partner is your sole estate beneficiary or is named as 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 the end of the year following your date of death. It is important to note that this rollover must be completed within this exempt period and your survivor is required to file CRA Form 240 to designate this contribution as a "survivor payment" within 30 days of the rollover contribution date. 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 becomes a taxable trust requiring an annual T3 trust return. Any unpaid income earned after your death is taxable 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.

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.

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