The Navigator

Strategies to Incorporate the Tax-Free Savings Account (TFSA) Into Your Financial Plan

Maximizing the benefits of your TFSA

This article discusses the flexibility of a TFSA. Depending on your stage of life and your financial priorities, there are strategies that can help you get the most from your TFSA.

This article outlines strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax advisor before acting on any of the information in this article.

Overview

TFSAs are a type of registered plan, and like all registered plans your contributions grow inside the plan without attracting tax; but the TFSA has some additional flexibility. Funds can be withdrawn tax-free at any time but you don't need to withdraw or take income from them until you are ready to do so. This means they can be used for a wide range of goals – from emergency savings, to renovations and other special purposes, or to supplement your retirement income. There are also some opportunities to income split to reduce the overall household income tax. You don't need to have earned income to contribute to a TFSA, although you do need to watch your contribution limits to avoid paying penalties for inadvertently contributing too much.

Income-Splitting Opportunities

Gifts to a Spouse

If there is a higher-income spouse and a lower-income spouse in your household, you may be able to benefit from income-splitting opportunities using the TFSA.

When a higher-income spouse provides funds to their lower-income spouse to contribute to their TFSA, because the income and capital gains earned in the TFSA are tax-free, there will be no attribution back to the higher-income spouse. Unlike a non-registered account, the income attribution rules will not apply to the income and capital gains earned in the TFSA.

This may help achieve family income-splitting, plus, as the funds in the account accumulate tax-free, there is no impact on any spousal tax credits that the higher-income spouse may be able to claim for the lower-income spouse.

Conventional income-splitting strategies consider the source of the funds being invested to determine the tax consequences. In contrast, when you gift funds to your spouse to invest in their TFSA, both you and your spouse can earn tax-free investment income, irrespective of which spouse provided the funds. The TFSA allows tax-free growth on the funds in the account, so there is greater potential for investment growth as the contribution made by each spouse builds over time.

It is also worth noting that if you have a lower-income spouse who has little or no earned income with which to build registered retirement savings

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plan (RRSP) contribution room, they 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.

Gifts to Adult Children

You can use a TFSA, in addition to a registered education savings plan (RESP), as a tax-sheltered way to supplement savings for your child's education. If you gift funds to a child who is at least 18 years old, they can contribute to a TFSA. They will not pay tax on the investment income they withdraw from the TFSA as they would with RESP withdrawals. Note however that contributions to a TFSA will not attract the Canada Education Savings Grant. In addition, once you make the gift, you will no longer be able to control how it is invested, when and how much is withdrawn and how the money is used.

Please note that in certain provinces and territories, the age of majority is 19. In these jurisdictions, a person who is 18 will accumulate TFSA contribution room for the year but will not be able to open the TFSA until they reach age of majority.

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 are no longer working but have cash flow that you don't need right away, you can continue building your savings even though you no longer have earned income with which to generate RRSP contribution room. The TFSA provides a way to save in a tax-free environment.
- You can contribute to this tax-free savings vehicle even after the end of the year you turn 71 when you are no longer able to contribute to your RRSP. If you are receiving either the required annual minimum registered retirement income fund (RRIF) 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 and you will not be required 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, which would be fully taxed at a higher future tax rate, withdrawals from a TFSA are not taxable.
- 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. A couple of examples of federal income-tested benefits are the Guaranteed Income Supplement and the Age Credit. The fact that TFSA withdrawals are not taxable also means that the withdrawals will not affect Old Age Security (OAS) claw back.

The TFSA Can Complement Your Existing Registered Savings Plans

Depending on your financial circumstances and your stage of life, you may be able to use the TFSA to complement your existing registered savings plans in the following ways:

> If you have RRSP contribution room, consider making a contribution and using the tax refund you receive to contribute to a TFSA.

- If you have RRSP 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 RRSP contributions based on your available contribution room or if you can no longer make RRSP 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 in the following year.
- 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 able to open their own account, and you can withdraw funds tax-free when they are needed.
- If you have investments in non-registered accounts, consider contributing them in-kind to your TFSA, up to your allowable TFSA contribution limit. This could trigger capital gains, which may result in an immediate tax liability.
- If you are unable to fund both an RRSP and a TFSA during your peak earning years when you are in a higher tax bracket, contributing to your RRSP may make sense to give you the benefit of the income tax deduction. You could then withdraw the funds from your RRSP 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 re-contribute the funds you have withdrawn since these withdrawals create new contribution room in the year after the withdrawal.

Create an Emergency Fund

You may wish to use the TFSA to help create an emergency fund. As these funds may be needed urgently and have to hold their value, consider more secure, less volatile interest-earning securities. As interest in a non-registered account is not favourably taxed, compared with Canadian dividend income and capital gains, the TFSA may be a great place to shelter your interest income producing investments. 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.

Summary

The TFSA offers greater flexibility in saving and investing throughout your lifetime and can provide a source of income in retirement. If you make the maximum contribution to your RRSP every year and are looking for additional ways to shelter investment income and capital gains from taxation, a TFSA can be a great complement even though you will not receive a deduction for the amount of your contribution.

Please contact us for more information about the topics discussed in this article.