Wealth Management

RBC Wealth Management Services

Tax-Free Savings Account

How the TFSA can help you reach your financial goals

The Tax-Free Savings Account (TFSA) is a flexible savings vehicle. It allows you to earn tax-free investment income which may help you reach your financial goals more quickly. The TFSA complements existing savings plans including your Registered Retirement Savings Plan (RRSP) and your Registered Education Savings Plan (RESP). This article describes how the TFSA can benefit you and how to avoid some pitfalls and anti-avoidance rules that may apply. This article covers the following topics:

- What is a TFSA?
- Opening your TFSA
- Contributions
- Over-contributions
- Withdrawals
- Fees Related to your TFSA
- Breakdown of marriage
- U.S. citizens resident in Canada
- Non-residents
- Carrying on a business
- Appendix: Anti-avoidance rules

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

The TFSA program began in 2009 as a way for you to save and grow your savings in a tax-free manner.

What is a TFSA?

The TFSA program began in 2009 as a way for you to save and grow your savings in a tax-free manner. Contributions to your TFSA are not tax-deductible. Any income (including capital gains) that you earn in your TFSA is exempt from tax. For this reason, any interest you pay on money borrowed to contribute to your TFSA is not tax-deductible since you are not borrowing for the purpose of earning taxable income. Similarly, if you realize capital losses in your TFSA, you cannot use them to offset capital gains realized outside your TFSA. Any withdrawals you make (whether from capital or income) are tax-free and will increase your contribution room in future years. In addition, if you contribute less than the annual contribution limit, you can carry forward any unused contribution room indefinitely.

Opening your TFSA

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. The other differences between the types of TFSAs are more pronounced upon death. For more details on the tax implications of TFSAs at death, please ask your RBC advisor for our article on “Estate Planning for Your TFSA”.

If you are a Canadian resident, have reached the age of majority in your province, and have a valid social insurance number, you are eligible to open a TFSA. In the year you turn 18, you will accrue the full TFSA dollar limit for that year. Certain provinces and territories, including Newfoundland and Labrador, New Brunswick, Nova Scotia, British Columbia, Northwest Territories, Yukon and Nunavut have set the age of majority to 19 years of age. If the age of majority is over 18 years of age in your province or territory, you will still accumulate contribution room for the year you turned 18 and be able to carry it forward to any future year.

Contributions

Your contribution room

The maximum amount you can contribute is limited to your TFSA contribution room. The total TFSA contribution limit from 2009 to 2018 is $57,500. The annual TFSA dollar limits from 2009 to 2018 are as follows:

Year	TFSA annual dollar limit
2009 - 2012	$5,000
2013 - 2014	$5,500
2015	$10,000
2016-2018	$5,500

The annual contribution limit will be indexed to inflation and rounded to the nearest $500.

You automatically accumulate contribution room each year (starting in 2009) if you were a resident of Canada at any time during the year and you are at least 18 years of age. You do not have to open a TFSA or file an income tax return to earn contribution room. Your income level has no bearing on your contribution room. Although the Canada Revenue Agency (CRA) will track your contribution room, you should also maintain your own records to keep track of your TFSA transactions.

Your contribution room decreases with any contributions you make, including re-contributions of funds you have withdrawn in previous years. On the other hand, investment income earned within your TFSA or the value of your investments held within your TFSA will not affect your contribution room.

If you do not use your contribution room in a particular year, you can carry forward the unused room throughout your lifetime to any future year. An attractive feature of the TFSA is that there is no age limit that restricts your ability to continue

Only the holder of a TFSA can make contributions to their own TFSA.

making contributions. There is also no lifetime limit on the amount you can contribute.

Who can contribute to a TFSA

Under the Income Tax Act, only the holder of a TFSA can make contributions to their own TFSA. This means that a corporation owned by you, or a trust of which you are a beneficiary, cannot make a direct contribution to your TFSA. In general, if a third party wants to make a contribution to your TFSA, they will first need to transfer the funds to your non-registered account. You can then contribute these funds to your TFSA.

Multiple TFSAs

You can maintain more than one TFSA at a time as long as your total annual contributions do not exceed your contribution limit. You can transfer funds from one TFSA account to another or from one financial institution to another without tax consequences if your financial institution completes a **direct transfer** for you.

If you withdraw funds from your TFSA and contribute those funds to another TFSA, it will be treated as a withdrawal and a contribution (instead of a direct transfer), which will affect your contribution room for the year. If you do not have sufficient contribution room, you will be subject to tax on any excess contributions. For more information regarding excess contributions, please refer to the section on “Over-Contributions”.

Foreign funds and investments

If your financial institution allows, you can contribute foreign funds to your TFSA. Your financial institution will have to convert the contribution amount to Canadian dollars (using the exchange rate on the date of the transaction), when reporting the contribution to the CRA. The total amount of the contribution, in Canadian dollars, should not exceed your available contribution room. Otherwise, you will be subject to penalties.

If you hold foreign investments within your TFSA, distributions may be subject to foreign withholding tax. You cannot claim this withholding tax as a foreign tax credit on your personal income tax return.

In-kind contributions

When you transfer assets in-kind to your TFSA from your non-registered account, the transfer is a taxable disposition. You will be considered to have disposed of the assets for their fair market value (FMV) at the time of transfer. If the assets are in a gain position, you will have to report the resulting capital gain on your income tax return for that year. If the investment is in a loss position, you cannot claim the resulting capital loss. The amount of the contribution to your TFSA will be equal to the FMV of the investment at the time it is contributed.

Transfers from your RRSP

Swap transactions occur when you exchange securities in your TFSA for cash, or other securities of equal value, between your registered or non-registered accounts. Swap transactions are not allowed and are discussed more in more detail in the Appendix on “Anti-Avoidance Rules”.

You cannot directly transfer an investment from your RRSP to your TFSA. You can make a taxable withdrawal from your RRSP and withholding tax will apply on the withdrawal. You can then contribute the FMV of the investment less the amount of tax withheld on the RRSP withdrawal to your TFSA.

Income splitting using a TFSA

As an income splitting strategy, you can gift money to your spouse, common-law partner, or adult child to contribute to their TFSA. Any income earned or capital gains generated within the TFSA will not attribute back to you while the funds remain in the TFSA. If you have a lower income spouse, common-law partner or adult

Over-contributions will be subject to a tax of 1% of the highest excess amount in the month, for each month you are in an over-contribution position.

child, this strategy can help them earn tax-free investment income and save for retirement or other goals.

Over-contributions

Over-contributions occur when you contribute more than your TFSA contribution room. You will be subject to a tax of 1% of the highest excess amount in the month, for each month you are in an over-contribution position. You will need to file Form RC243, Tax-Free Savings Account (TFSA) Return, with the CRA by June 30 of the following year and pay any taxes you owe by this date. You will also need to complete and file RC243-SCH-A, Schedule A – Excess TFSA Amounts to help you calculate the amount of taxes you owe.

The 1% tax will continue to apply for each month that the excess amount remains in your TFSA. To stop the tax from accruing, you need to either withdraw the excess amount from your TFSA or receive new contribution room to absorb the over-contribution, which occurs on January 1st of the following year. There is no CRA form that needs to be completed to withdraw the excess amount.

Withdrawals

You can generally withdraw any amount from your TFSA at any time, without tax consequences. However, depending on the type of investments you hold within your TFSA, you may need to time your withdrawals accordingly. For example, if you invested in a non-redeemable guaranteed investment certificate (GIC), you may have to wait until it matures.

Withdrawals do not reduce the amount of contributions you have made for the current year. Instead, the full FMV of the withdrawal will be added to your contribution room at the beginning of the following year. For example, an amount you withdraw in 2018 can be re-contributed to your TFSA starting January 1, 2019. This means that you can withdraw funds from your TFSA as needed and re-contribute them in a later year. If you re-contribute any amount withdrawn in the same year (without having unused contribution room) you may have over-contributed and be subject to penalties.

How much you can re-contribute depends on how much you withdrew from your TFSA. Let's take a situation where you invested $10,000 five years ago and your investment has increased in value to $25,000 in the current year. If you withdrew the full $25,000 in the current year, then starting January 1 of the following year, you can re-contribute $25,000 plus the $5,500 of new contribution room earned for that year for a total of $30,500 plus any unused TFSA contribution room you accrued from previous years. On the other hand, suppose you had invested $10,000 but the investment decreased in value to $2,000. If you withdrew this amount in the current year, then starting January 1 of the following year you can re-contribute only $2,000 plus the $5,500 of new contribution room earned for that year for a total of $7,500 plus any unused TFSA contribution room you accrued from previous years.

Certain withdrawals may not be added back to your contribution room for the following year. These include withdrawals of deliberate over-contributions, prohibited investments, non-qualified investments, amounts attributable to swap transactions and income or capital gains earned on any of these items.

Impact of withdrawals on your government benefits and credits

Any income earned in your TFSA or withdrawals you make from the account will not affect your federal income-tested benefits such as Old Age Security benefits, the Guaranteed Income Supplement, and Employment Insurance benefits. The income earned or withdrawal you make from your TFSA will also not impact your entitlement to federal tax credits such

If you are a U.S. citizen or green card holder who is required to file U.S. income tax returns, you may not benefit from a TFSA.

as the age amount, the GST/HST credit, the working income tax benefit or the Canada Child Benefit.

Fees related to your TFSA

If you incur any fees in relation to your TFSA, such as account maintenance, administration, transfer transaction fees and management fees, these are not tax deductible regardless of where the fees are paid from. (We are not referring to management fees and operating expenses of a mutual fund that are absorbed within the mutual fund, unless these are charged separately to the unitholder).

When fees are charged to your TFSA, they are not considered withdrawals that could be recontributed the following year. Currently, if TFSA fees are paid directly from your non-registered account, they are not considered contributions to your TFSA. However, if you transfer funds into your TFSA from your non-registered account to pay the fees, that transfer will be considered a contribution.

In November 2016, the CRA announced a change to its administrative position that allows you to pay fees relating to your TFSA from your non-registered account. The CRA has taken the position that the payment of registered account fees from a non-registered account will be considered a benefit and will attract a penalty tax of 100% of the fee. For example, if you pay your TFSA fee of $1,000 from your non-registered account, you could be penalized $1,000 by the CRA. The CRA has stated that they will not apply this penalty before January 1, 2019 (provided that such payments do not relate to services to be provided after 2018). If you currently pay your registered plan fees from an account other than the registered plan, you may wish to discuss these changes with your qualified tax advisor.

Breakdown of marriage or common-law partnership

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 or common-law partner's TFSA without tax consequences. Your financial institution must complete a direct transfer for you. If you simply withdraw from your plan and then have your former spouse or common-law partner contribute to their TFSA, this would have a taxable result. However, a direct transfer will not affect your or your former spouse or common-law partners' 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.

U.S. citizens resident in Canada

If you are a U.S. citizen or green card holder who is required to file U.S. income tax returns, you may not benefit from a TFSA. Income earned in your TFSA will be taxable for U.S. purposes in the year it is earned. There may also be additional reporting requirements depending on the type of TFSA you own. For more information on U.S. citizens or green card holders with TFSAs, please ask your RBC advisor for our article on "Tax Planning for U.S. Citizens Resident in Canada".

Non-residents of Canada

You are allowed to keep your TFSA if you become a non-resident of Canada. You will not need to pay Canadian taxes on any income earned or capital gains generated in the account. You will also not need to pay Canadian taxes on any withdrawals you make. You may want to consider obtaining professional tax advice in your country of residence to determine how the

If the CRA determines that a TFSA is "carrying on a business" of trading securities, the income from that business may be taxable.

funds in your TFSA will be treated for tax purposes in that jurisdiction.

The TFSA limit is not pro-rated for the year you move from or to Canada. You are entitled to the full amount of contribution room in either of those years. If you are a non-resident for an entire calendar year, you will not accrue contribution room for that year.

You can make a TFSA contribution up until the date you become a non-resident of Canada. If you make a contribution to your TFSA while you are non-resident, you will be subject to a 1% tax for each month the contribution stays in your account. The penalty will continue to apply until you withdraw the full amount of the contribution from your account (and designate it as a withdrawal of non-resident contributions) or become a resident of Canada. If the 1% tax applies to you as a non-resident, you will need to file Form RC243, Tax-Free Savings Account (TFSA) Return, and Form RC243-SCH-B Schedule B – Non-Resident Contributions to a Tax Free Savings Account (TFSA). If the contribution you made while you were a non-resident is also in excess of your TFSA contribution room, you may be subject to an additional tax of 1% per month and have to file Form RC243-SCH-A Schedule A – Excess TFSA Amounts.

Generally, withdrawals (that are not excess contributions or contributions made while a non-resident) you make while you are a non-resident will be added back to your TFSA contribution room for the following year. This contribution room will not be available to you until you become a Canadian resident again.

Carrying on a business

TFSA's are intended to be a part of a personal financial plan to fund goals. If the CRA determines that a TFSA is "carrying on a business" of trading securities, the income from that business may be taxable. Whether the TFSA is carrying on a business depends on many different factors including how frequently the securities are traded, the length of time the securities are owned, the holder's knowledge or experience in the securities markets and whether the securities are considered speculative in nature. A key trigger for the CRA seems to be where the FMV of the account is significantly higher than the total maximum TFSA contributions that can be made to date. If the CRA determines that a TFSA is carrying on a business of trading in securities, taxes are imposed on the income earned by the TFSA. Income that is subject to tax within the TFSA includes dividends and interest and the full amount of gains net of losses. Gains and losses do not get the benefit of the normal 50% inclusion rate because the TFSA is viewed as carrying on a business of trading securities.

In addition, it is possible that second and subsequent generation income earned on the income from a business carried on by the TFSA may have to be distributed to the TFSA holder and taxed in their hands.

Conclusion

The TFSA may help you achieve greater flexibility in saving and investing throughout your lifetime. Speak to your RBC advisor for more information about TFSAs or to discuss how a TFSA can be incorporated into your financial plan.

This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax, or insurance 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, legal, and/or insurance advisor before acting on any of the information in this article.

Appendix: Anti-avoidance rules

The qualifying investments you are permitted to hold in your TFSA are the same as those permitted in your RRSP. These include (but are not limited to): cash, mutual funds, securities listed on a designated stock exchange, GICs, bonds and certain shares of small business corporations. Holding non-qualified and prohibited investments in your TFSA will result in penalties and filing requirements.

Non-Qualified investments are investments that do not meet the definition of "qualified investment" under the Income Tax Act. Examples of non-qualified investments include shares in private investment holding companies or foreign private companies, shares that become delisted from a designated stock exchange, and real estate. Prohibited investments include debt or shares, or an interest in, entities in which the TFSA holder or a non-arm's length person has a "significant interest" (generally 10% or more ownership) or entities with which the TFSA holder does not deal at arm's length.

The consequences of investing in a non-qualified or prohibited investment inside your TFSA can be quite harsh. In the year you purchase the non-qualified or prohibited investment inside your TFSA or in the year an investment becomes non-qualified or prohibited, you may incur a one-time penalty tax of 50% of the FMV of the investment.

If you did not know and could not have known, at the time the investment was obtained, that the investment was or would become non-qualified or prohibited, and you dispose of the investment from the TFSA or the investment ceases to be non-qualified or prohibited by the end of the year following the year in which the tax applied (or at a later time as permitted by the Minister of National Revenue), then this penalty tax can be refunded to you.

If you earn any income or capital gains on the non-qualified investment, the trustee of your TFSA is required to file a T3, Trust Income Tax and Information Return. Your TFSA will have to pay tax at the top marginal tax rate on this income and will not get the benefit of the 50% inclusion rate for capital gains.

Any income or capital gains that a prohibited investment earns will be considered an "advantage" and is subject to a 100% penalty tax.

A swap transaction is a transfer of assets (other than a contribution or withdrawal) between your TFSA and yourself (or a person with whom you do not deal at arm's length). Swap transactions are not allowed. If you engage in a swap transaction, the increase in the total FMV of the TFSA as a result of the swap transaction is considered an "advantage" and is subject to a 100% penalty tax. In addition, all future increases in the FMV of the TFSA that are reasonably attributable to the initial swap transaction will be considered an advantage. Therefore, any dividends, interest or other amounts paid on the swapped security, any appreciation in value of the swapped security or on any substituted property, and any income earned on income, would be subject to the advantage tax.

There is an exception to these rules. You can swap a non-qualified or prohibited investment from your TFSA with cash or other property of equal value that you hold outside of your TFSA provided that you are entitled to the refund of the 50% penalty tax on the non-qualified or prohibited investment.

If you are required to pay any of these penalty taxes associated with non-qualified investments, prohibited investments, or advantages, you must complete and file Form RC243, Tax-Free Savings Account (TFSA) Return by June 30 of the year following the year in which the tax arose. Dealing with these penalty taxes is quite complex so you should consult with a professional tax advisor if you find yourself in this situation.

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