Understanding the TFSA

Tax Free Savings Account

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What Is A Tax-Free Savings Account? (TFSA)

Effective January 1, 2009 the Tax-Free Savings Account (TFSA) is available to Canadian residents age 18 or older.

The Government of Canada introduced the Tax-Free Savings Account (TFSA) with the 2008 Federal Budget, and calls it “the single most important personal savings vehicle since the introduction of the Registered Retirement Savings Plan (RRSP).”

As with the RRSP, the TFSA is intended to help Canadians save money and plan for future expenses. The primary difference is money contributed to a TFSA is in *after-tax dollars* and, as a result, is not subject to tax upon withdrawal.

The primary benefits of the TFSA include:

- ***Tax-Sheltered Savings***

  A TFSA will allow taxpayers to set money aside in an account and invest without being taxed on interest and investment earnings throughout their lifetime. The elimination of taxes on earnings and capital gains will help savings grow faster.

  All income levels and walks of life can benefit from a TFSA.

- ***Flexibility***

  Unlike an RRSP or an RESP, a TFSA can help you save for any purpose. There are no restrictions, no matter what age, on the way the funds in the account are used.

  Therefore, you can use a TFSA to save for a car, a home, to start a small business or even to take a vacation.

  Even if a taxpayer does not open nor contribute to a TFSA, they will still accumulate contribution room throughout their life.

Who Could Benefit from a TFSA?

The TFSA is an exciting, new and unique registered product for Canadians. It allows us to save for lifetime needs as well as emergencies, and until we require the funds, investments grow faster because of their tax-free status.

The TFSA fills a unique spot in the line-up of registered products from which Canadians have to choose. Who would be interested in a TFSA? Examples include young people just starting out, people already saving in taxable savings accounts, retirees who have reached age 71 and are required to take their minimum RRIF distribution, low-income earners and Canadians saving for every day and emergency needs. (Examples and illustrations can be found at the end of this booklet.)

However, TFSA Holders must remember a TFSA is not a chequing account. To benefit from the potential earnings growth of a portfolio, the Holder of a TFSA needs to leave the money invested for a period of time.

Who can hold a TFSA?

Only an individual can open a TFSA. This person is called the "Holder." Any person (not trusts or corporations) meeting all of the following three requirements is eligible to establish a TFSA:

- Resident in Canada
- 18-years of age or older
- With valid Social Insurance Number (SIN)

There is no maximum age requirement, and an individual may have multiple TFSAs.

Types of TFSA

There are three basic types of TFSA: deposit, mutual fund and self-directed plans. Different types of plans permit different investments with the self-directed plans allowing the most diverse selection of investment categories.

Qualified Investment in a TFSA

A TFSA would generally be allowed to hold similar types of investments as an RRSP.

The types of investments are restricted under the *Income Tax Act* (Canada) and include:

- Variable Interest Savings Accounts
- Term Deposits and GICs
- Credit Union Shares
- Index-linked Term Deposits
- Mutual Funds
- Publically Traded Securities
- Bonds

There are restrictions on non-arms length transactions under a Self-Directed TFSA.

Contributions and Withdrawals

Contributions

As the account holder you are the only person who can do the following with your TFSA:

- make contributions;
- make withdrawals; and
- determine how the funds are invested.

The annual TFSA dollar limit for the years **2009**, **2010**, **2011** and **2012** was **$5,000**.

The annual TFSA dollar limit for the years **2013** and **2014** was **$5,500**.

The annual TFSA dollar limit for **2015** is **$10,000**.

The annual TFSA dollar limit for **2016** is **$5,500**.

Unlike the RRSP, TFSA contributions are made with after-tax dollars and are not deducted from earned income.

Investment income (including interest, dividends and capital gains) will grow tax free, and will not be taxed even when withdrawn.

Transfers in kind are allowed as contributions to a TFSA provided that the property is a qualified investment.

As with an RRSP, for an in-kind contribution there is a deemed disposition at the time of contribution. If the fair market value exceeds the cost of the property, the capital gain must be reported on an income tax return. Should the cost exceed the fair market value, resulting in a capital loss, the loss cannot be claimed. The amount of the contribution will be equal to the fair market value of the property.

It is essential to keep track of all TFSA contributions, especially if the Holder has multiple TFSA accounts because the annual contribution limit is per person NOT per plan.

Withdrawals

A TFSA Holder may withdraw funds at any time and at any age, unless restricted by investment terms (e.g. 3 year fixed deposit).

Withdrawals are not reported as taxable income and are not subject to withholding tax.

When money is withdrawn from a TFSA, the contribution room is not lost. Funds taken from a TFSA are added back to the Holder's unused contribution room the following year.

TFSA withdrawals of contributions/earnings will increase contribution room for future years, but not the current year. Withdrawals made during the current year should not be re-contributed to a TFSA until the following year, to avoid an over-contribution.

The withdrawal of amounts in respect of deliberate over-contributions, prohibited investments, asset transfer transactions and income related to those amounts do not constitute distributions for TFSA purposes and thus do not create additional TFSA contribution room.

If a TFSA Holder contributed the annual contribution limit of $5,000 and, through successful investing, in one year the value increased to $7,500. S/he could withdraw the $7,500, and the following year the contribution room would increase by $7,500 *plus* the annual contribution limit.

On the other hand, if a TFSA Holder contributed the $5,000 annual contribution, saw the value decrease to $2,000, and took a $2,000 withdrawal then the following year the contribution room would only increase by $2,000 (plus the annual contribution limit). The $3,000 in contribution room from the original $5,000 annual contribution would be lost.

Investors cannot claim capital losses on investment losses in a TFSA.

Withdrawals will not impact eligibility for income tested benefits and credits. (e.g. OAS, GIS, Age Credit, GST, EI, child-tax benefit, working income tax benefit.)

Any amount withdrawn will be reflected as an increase to the following year's unused contribution room on the individual's Notice of Assessment from CRA.

Unlike withdrawals, most transfers will not affect the Holder's unused contribution room. Additionally, withdrawals for the purpose of correcting an over-contribution will not affect the Holders' unused contribution room.

Unused Contribution Room

When an individual contributes less than the maximum amount, the difference is referred to as "unused contribution room."

Unused contributions may be carried forward indefinitely and used in future years. Therefore, after 2009, an individual could feasibly contribute more than the maximum annual contribution limit in a given year.

There is no limit to how much contribution room can be carried forward.

A TFSA withdrawal increases the contribution room for the year after the withdrawal by the amount of the withdrawal.

Canada Revenue Agency (CRA) will confirm unused contribution room on taxpayer's annual Notice of Assessment and/or by letter.

Over-contributions

Since individuals can hold a TFSA at multiple institutions, it is important to make sure not to over-contribute.

The Holder is responsible for ensuring the maximum contribution limit is not exceeded.

An over-contribution will result in a penalty tax on the amount over-contributed of 1% per month for each month the over-contribution amount remains in the TFSA.

A withdrawal to correct over-contributions does not increase unused contribution room.

Contribution Room Illustration

In 2009, Sue contributes $2,000 to her TFSA, leaving unused contribution room of $3,000. In 2010, she accumulates additional yearly contribution room of $5,000 and now has a total of $8,000 in unused contribution room.

In 2010, Sue takes a withdrawal of $1,000 for a holiday. That $1,000 will be added to the contribution room for 2011.

Sue's unused contribution room for 2011 would be $14,000, consisting of $8,000 carried forward from 2010, $5,000 additional annual contribution limit for 2011 and $1,000 from the withdrawal taken in 2010.

Sue has not contributed to her TFSA in 2012 and subsequent years. Her unused contribution for 2016 would be $45,500, consisting of $5,000 carried forward from 2012, $5,500 from 2013, $5,500 from 2014, $10,000 from 2015 and $5,500 from 2016.

Year	Contribution	Withdrawal	Contribution Room
2009	$ 2,000	$ 0	$ 3,000

2010	$ 0	$ 1,000	$ 8,000
2011	$ 0	$ 0	$14,000
2012	$ 0	$ 0	$19,000
2013	$ 0	$ 0	$24,500
2014	$ 0	$ 0	$30,000
2015	$ 0	$ 0	$40,000
2016	$ 0	$ 0	$45,500

Year	Unused Contribution Room Breakout
2009	$ 5,000 (Annual Contribution Limit) – $ 2,000 (2009 Contribution) = **$3,000**
2010	$ 3,000 (Unused Contribution Room) + $ 5,000 (Annual Contribution Limit) = **$8,000**
2011	$8,000 (Unused Contribution Room) + $5,000 (Annual Contribution Limit) + $1,000 (2010 Withdrawal) =**$14,000**
2012	$14,000 (Annual Contribution Limit) + $5,000 (2009 Contribution) = **$19,000**
2013	$19,000 (Annual Contribution Limit) + $5,500 (2009 Contribution) = **$24,500**
2014	$24,500 (Annual Contribution Limit) + $ 5,500 (2009 Contribution) = **$30,000**
2015	$30,000 (Annual Contribution Limit) + $10,000 (2009 Contribution) = **$40,000**
2016	$40,000 (Annual Contribution Limit) + $5,500 (2009 Contribution) = **$45,500**

CRA Notice of Assessment

CRA will determine TFSA unused contribution room based on information provided by issuers for each eligible individual who files an annual T1 individual income tax return.

This information will be provided on the taxpayer's Notice of Assessment and will confirm unused contribution room each year.

Individuals who have not filed in prior years (because, for example, there was no tax payable) would be permitted to establish their entitlement to contribution room by filing a return for those years or by other means acceptable to CRA.

Individuals who do not have a taxable income and do not file a tax return do not receive the annual CRA Notice of Assessment. Those individuals will have to file a NIL T1 Return to confirm TFSA contribution room.

Transfers

A Tax-Free Savings Account (TFSA) is transferable to:

- Another TFSA owned by the Holder, unless restricted by investment terms (e.g. 3 year fixed deposit).
- A spouse/common-law partner on the death of the Holder.
- Former spouse/common-law partner on a relationship breakdown.

In all of the above cases, a transfer will not affect the contribution room of the holder of the account receiving the funds.

A Holder can transfer from one TFSA to another TFSA in his or her name provided the funds go directly to the new TFSA. If funds are paid out first it would be considered a withdrawal. When funds are withdrawn, TFSA contribution room is not reinstated until the next year, so withdrawing funds to re-contribute to a new TFSA in the Holder's name could result in an over-contribution penalty situation.

It is important to keep track of all of TFSA contributions as the annual contribution limit is per person not per plan.

Transfer Due to Death of Holder

Anyone may be appointed as the beneficiary of a TFSA. Upon the death of a TFSA Holder the following applies:

- ### *Spouse as Successor Holder/Beneficiary*

  A TFSA Holder may appoint his or her spouse or common-law partner as the Successor Holder/beneficiary.

  Upon death of the Holder the spouse/ common-law partner may transfer the funds while maintaining their tax-free status into a new or existing TFSA in his or her own name.

  This transfer will have no impact on the TFSA contribution room of the surviving spouse/ common law partner.

- ### *Spouse as Beneficiary in Will but not in TFSA Contract*

  When no spouse or common-law partner is named in the TFSA contract as beneficiary, but is named as beneficiary in the Will, they become the "survivor" and as such, are therefore entitled to the amounts paid under the TFSA. These payments can be made into the survivor's TFSA account during the exempt period (up to the end of the calendar year of the Holder's death) without affecting the survivor's contribution room. In order to designate these payments as exempt, CRA form RC240 must be filed within 30 days of the exempt contribution.

- ### *Person Other than Spouse as Beneficiary*

  The Holder of a TFSA may designate someone other than the spouse/common- law partner as beneficiary or may choose not to name any beneficiary at all.

  In the event the beneficiary is not the spouse or common-law partner, the TFSA ceases to maintain its tax-free status as of the date of death of the Holder.

  Any increase in value of the TFSA after date of death becomes taxable income either of the beneficiary or of the deceased's estate, depending on the circumstances and the date of payments.

In any of these circumstances, the fair market value (FMV) of the TFSA as of date of death is tax-free.

Transfer Due to a Relationship Breakdown

All or part of a TFSA is transferable to a former spouse or common-law partner on the breakdown of a relationship.

TFSA transfers can be made directly to a former spouse or common-law partner's TFSA without affecting their contribution room. The individuals must be living separately and apart at the time of the transfer, and the transfer must be under a decree, order or judgment of a competent tribunal, or under a written separation agreement.

A transfer due to relationship breakdown neither increases the contribution room of the Holder, nor decreases the contribution room of the transferee.

Borrowing Money to Purchase a TFSA

Interest on money borrowed to invest in a TFSA is not deductible for tax purposes.

Use of a TFSA as Security for a Loan

The Holder may pledge his or her TFSA contract as security for a loan where:

- the loan is an arms-length transaction, and
- no-one other than the Holder will receive a taxable benefit of any kind from the proceeds of the loan.

Where a loan does not meet the requirements under the *Income Tax Act*, CRA may deem the contract not to be a TFSA and the contract is no longer tax sheltered.

Non-Resident Holders

If the Holder of a TFSA is no longer a resident of Canada, he or she may keep the TFSA open, however,

- No contributions may be made.
- No contribution room will accumulate.

Withdrawals made during the period the Holder is a non-resident will be added back to the Holder's unused contribution room the following year, but will only become available when the Holder subsequently resumes Canadian residency status.

If a non-resident Holder makes a contribution, the Holder is subject to a 1%/month penalty fee on the contributed amount for each month the contribution remains in the TFSA.

These rules apply while the Holder is a non-resident. If the Holder becomes a resident of Canada again, contribution room will commence accruing and the Holder can make future contributions.

TFSA Penalties

Account Advantages and Benefits

Advantages and benefits based on TFSA holdings are subject to a tax penalty.

The *Income Tax Act* stipulates that a TFSA Issuer cannot give the holder any benefits or advantages that are conditional in any way on the existence of the plan.

Benefits or advantages based on TFSA holdings such as merchandise, trips or interest free loans are subject to a penalty tax.

Any other allowable benefit must go into the TFSA, and not to the Holder or to a person with whom the Holder is not dealing with at arm's length.

On October 16, 2009 the Department of Finance proposed the following amendments to the *Income Tax Act* to curtail various strategies involving TFSAs.

- **Asset transfer transactions**, or "swap transactions", between a TFSA and any other account of the taxpayer (or a family member) will be effectively prohibited. Any amount swapped into a TFSA in this way will be subject to a 100% tax.
- **Over-contributions** above the annual limit are subject to a tax of 1% per month. In addition, any income attributable to deliberate over-contribution will be taxed at 100%.
- **"Prohibited investments"** such as shares of the TFSA owner's corporation are subject to a 50% refundable tax. In addition, any income from a prohibited investment will be taxed at 100%.
- **Income attributable to "non-qualified investments"** will be taxable at regular income tax rates, as well as any income earned on such income.
- **Non-qualified investments.** If at any time in a taxation year the TFSA holds non-qualified investments, the TFSA trust will be taxable on any income earned or capital gains realized from the non-qualified investments.

No Attribution Rule

Typically if an individual transfers property to his or her spouse or common-law-partner, the income earned on the transferred property is treated as income of the transferor.

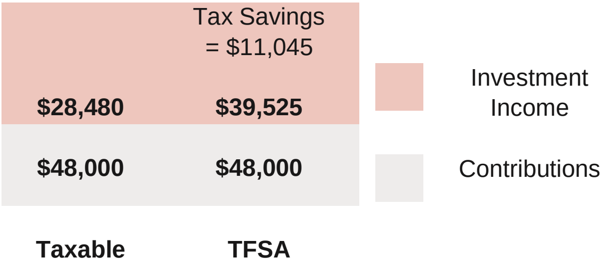
The TFSA provides an exception to these “attribution rules.” Individuals can take advantage of the TFSA contribution room available to them using funds provided by their spouse or common-law partner without the spouse or common-law partner incurring a tax liability on the income earned.

TFSA vs. Unregistered Account

Since capital gains and earned income are not taxed in a TFSA, savings grow faster.

A person contributing $200 a month to a TFSA and earning 5.5% per year would experience an additional $11,045 in savings compared to an unregistered account.

TFSA vs. Unregistered Savings Illustration



Methodology: The results above show a combined federal and provincial tax savings based on a $200 monthly contribution for 20 years at a 5.5% rate of return. For unregistered savings a 21% average tax rate on investments is assumed (based on 40% interest, 30% dividends and 30% capital gains and a middle-income earning account holder). *Source: Department of Finance, Canada*

TFSA vs. RRSP

Both the RRSP and the TFSA offer tax-free savings, but here are some key differences:

	RRSP	TFSA
Tax Deductible Deposits	YES	NO
Tax-Sheltered Growth of Investments	YES	YES
Taxed Withdrawals	YES	NO
Spousal Contributions	YES	NO*
Unused Contribution Carry-Forward	YES	YES

Withdrawals Increase Contribution Room	NO	YES
Withdrawals Affect Federal Government Benefits	YES	NO
Maximum Age Limit	YES	NO
Contribution Limit Based on Earned Income	YES	NO
Maximum Contribution (2015)	Lesser of $24,930 or 18% of earned income	$5,500

* An individual may give funds directly to a spouse or common-law partner to contribute to his or her own TFSA.

One aspect to consider when deciding whether to contribute to a TFSA or RRSP is how an investor's tax rate at the time of withdrawal will compare to his or her current tax rate.

If at the time of expected withdrawal:

- The expected tax rate is similar to the investor's tax rate when contributing; the TFSA and RRSP are equally attractive.
- The expected tax rate is lower than the investor's tax rate when contributing; the RRSP is a better choice.
- The expected tax rate is higher than the investor's tax rate when contributing; the TFSA is a better choice.

Who Could Benefit from Owning a TFSA?

The flexibility and tax sheltered aspect of the TFSA make it an appealing new registered product for Canadians. Listed below are examples of potential situations where owning a TFSA would be more useful than an RRSP.

Savings for Planned and Unplanned Needs

There are many expensive purchases most people are required to make during their lifetime. A TFSA Holder can make a withdrawal from his or her TFSA without the income and tax consequences of making a withdrawal from an RRSP.

- Jack and Lily are a single income family. Since they were married, Jack has been making contributions to his TFSA and provides Lily with the funds to contribute to hers. They recently purchased a new refrigerator and found it was too small for its intended spot. They decided to renovate their entire kitchen. They each took out $5,000 from their TFSAs tax-free and will be able to re-contribute this amount in the future.

- Harold has been contributing $25 a month to a TFSA since his daughter was born and has earned about 5% per year. Twenty-five years later his daughter is getting married. Now, Harold has accumulated almost $15,000 in his TFSA, all of which can help pay for the wedding ceremony and gifts without tax consequences. The $15,000 will be reapplied to his contribution room the following year.

Benefits for Seniors

While the TFSA is good for young people who have a lot of time to see their savings grow in a tax efficient manner, seniors can also take advantage of a TFSA.

The maximum age limit for RRSP contributions is 71, at which point the Annuitant must convert it into a RRIF, and begin to draw down his or her savings. With the TFSA, there is no age restriction to contribute.

If a senior does not have the immediate need for the RRIF mandatory distributions, he/she can contribute them to a TFSA for continued tax-free growth.

- Cheryl is 72 and has to take a required minimum distribution from her RRIF this year. Her Old Age Security (OAS) benefits and private pension provide enough income for her everyday needs. So, she contributes the required minimum distribution from her RRIF to a TFSA where she invests in a GIC to mature just in time for the Caribbean cruise she has wanted to take for years. What's more, the money she withdraws from the TFSA for the cruise is not taxable and does not affect her OAS.

Benefits for Low Income Earners

It might be preferable for a low income earner to make a contribution to a TFSA. First, as a low income earner, they do not benefit as much from the tax deduction on RRSP contributions. In addition, withdrawals from an RRSP could reduce an income tested benefit. Withdrawals from a TFSA do not affect the National Child Benefit,

Guaranteed Income Supplement or Old Age

Security Benefits since withdrawals are not taxed or reported as income.

- Stephan is a low income earner who expects to receive the Guaranteed Income Supplement (GIS) in retirement in addition to Old Age Security (OAS) and Canada Pension Plan (CPP) benefits. He earns $2,000 a year in interest income from the savings he has put away in a TFSA. Neither this income, nor any withdrawals from the TFSA, will affect the GIS benefits (or any other federal income-tested benefits and credits) he receives in retirement. If this $2,000 were earned on an unregistered basis, it would reduce his GIS benefits.

Where Do You Go From Here?

Credit Union staff members are ready to discuss any aspects of the Tax-Free Savings Account (TFSA) which may not have been fully discussed in this brochure or which may need further clarification. Before investing in any TFSA, ask about deposit insurance protection.

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