



## Tax Planning with TFSAs

by Jamie Golombek



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Tax Free Savings Accounts (TFSAs) were introduced in the 2008 federal budget and are poised to become the tax planning investment vehicle of choice beginning in 2009, when funds can first be contributed into them.

According to the government, the TFSA is a “flexible, registered general-purpose account that will allow Canadians to earn tax-free investment income.”

### The basics

Anyone who is at least 18 years old is permitted to open a TFSA. The only requirement is that the individual have a social insurance number when the account is opened. There will be no limit to the number of TFSAs you can set up.

That being said, the amount you can contribute to a TFSA will be based on your “TFSA contribution room.” Starting in 2009, everyone who is at least 18 years old and a Canadian resident will begin to accumulate \$5,000 of TFSA contribution room (to be indexed annually, rounded to the nearest \$500). This TFSA contribution room will be cumulative and will be carried forward indefinitely to future years.

Perhaps the most interesting twist in these rules is that, unlike Registered Retirement Savings Plans (RRSPs) any

amounts withdrawn from your TFSA in a particular year will be automatically added to your TFSA contribution room for the following year, allowing individuals who withdraw TFSA funds to re-contribute an equivalent amount in a future year.

As with RRSPs, any excess contributions beyond the TFSA contribution limit will be taxed at one per cent per month.

Contributions “in kind” will be considered a deemed disposition, with a capital gain being reportable and any capital loss denied, just like with in-kind RRSP contributions.

Unlike RRSPs, but similar to Registered Education Savings Plans (RESPs), contributions to a TFSA are meant to come from after-tax funds (hence “tax pre-paid”) and therefore will not be tax deductible from income. The big advantage is that any income and gains on investments held within a TFSA won’t be taxed either while inside the TFSA or upon ultimate withdrawal.

This provides us with a number of specific planning opportunities.

### Savings planning for all Canadians

A 2003 C.D. Howe study (“New Poverty Traps: Means-Testing and Modest-Income Seniors” - [http://www.cdhowe.org/pdf/background\\_65.pdf](http://www.cdhowe.org/pdf/background_65.pdf)) concluded that “for many

lower-income Canadians, RRSPs are a terrible investment.”

That’s because many government benefits, credits and programs are based on net income and are substantially or even totally reduced as your income gets higher.

Canadians with low and modest income who receive the GST/HST Credit may find that even a small amount of taxable investment income can begin to reduce their credit. By earning all income tax-free inside a TFSA, the Credit may be preserved.

Similarly, parents who receive the Canada Child Tax Benefit (including the Child Disability Benefit) may find that taxable investment income reduces the amount of benefits to which they’re entitled. Earning such income inside a TFSA should help to preserve some of the otherwise reduced Benefits.

For seniors living on RRSP or Registered Retirement Income Funds (RRIFs) withdrawals, one of the biggest criticisms of the current system is that when the funds are withdrawn upon retirement, not only are they taxed at the retiree’s personal marginal tax rate but, in many cases, they affect the retiree’s eligibility for federal income-tested government benefits and credits, such as the Age Credit, the Guaranteed Income Supplement (GIS) or even Old Age Security (OAS) benefits.

Since withdrawals from the TFSA are not considered to be “income,” they will have no impact on the GIS or OAS nor will they reduce the age credit.

### **Developing a savings plan**

Many investors feel that it’s prudent to maintain a “rainy day fund,” a colloquial term used to describe funds that have been set aside in either cash or near-cash equivalents and that may be drawn upon in the event of that proverbial rainy day.

The philosophy behind a rainy day fund is that there should be an easily accessible source of money in the event something happens that requires a large, immediate and unexpected cash

outlay, for example, to repair a leaky roof (perhaps the true source of the term).

The problem with a rainy day fund is that traditionally, it’s not been very tax efficient. That’s because the cash or near-cash in such a fund is generally invested in highly-taxed, interest-bearing, fixed income investments.

Now with advent of the TFSA, an emergency fund can be tax-effectively established since all interest income earned, either on a high-interest savings TFSA or a money market mutual fund TFSA, will be tax-free for life.

This all-purpose fund can also be used for non-emergencies and accessed multiple times during one’s lifetime for various reasons, such as to buy a car, pay for a wedding, buy a home, etc.

### **Tax effective planning (TFSA or an RRSP?)**

One of the most common questions is if someone has limited funds, how do you choose between contributing to a TFSA or an RRSP?

The two plans are meant to be tax-neutral. The chart on the following page compares the after-tax accumulation over 20 years of \$5,000 in employment or business income earned by an individual, subsequently invested through a TFSA or an RRSP.

In the TFSA scenario, the \$5,000 is taxed upfront, when earned, at the individual’s marginal tax rate (assumed to be 40%) and the after-tax amount of \$3,000 is invested in the TFSA. Since this tax is literally “pre-paid” and since the earnings and growth inside the TFSA are not taxed during the accumulation phase, nor are they taxed upon withdrawal, the after-tax value after 20 years, assuming a 6% growth rate, is \$9,621.

In comparison, take the example of \$5,000 of income that you don’t pay tax on because it is put into your RRSP and a deduction is claimed for it. The \$5,000 invested grows to \$16,036 and is ultimately taxed upon withdrawal in 20 years at 40%. You net exactly the same amount after-tax, or \$9,621.

	TFSA	RRSP
Pre-tax income	\$5,000.00	\$5,000.00
Tax (40%)	(2,000.00)	n/a
Net contribution	\$3,000.00	\$5,000.00
Growth at 6% / 20 years	9,621.41	16,035.68
Tax upon withdrawal (40%)	-	(6,414.27)
Net cash	\$9,621.41	\$9,621.41

So, while it appears that the two plans produce the same results, this only holds true if your upfront tax rate is the same as your tax rate later on.

RRSPs will make more sense when the tax rate upon withdrawal is expected to be lower than the tax rate upon original contribution. Conversely, TFSAs will work out better if your tax rate (including the effect of RRSP withdrawals on benefits such as the Guaranteed Income Supplement or Old Age Security, which are clawed back based on income as discussed above) will be higher upon withdrawal than it was when you contributed.

But the math doesn't tell the full story, since TFSAs are much more flexible. For example, the savings withdrawn can be re-contributed back into the TFSA later on. This can't be done with RRSPs.

## Retirement planning

TFSAs can also help individuals who can't contribute to an RRSP for various reasons. For example, employees who are members of registered pension plans through their employers may find their ability to contribute to an RRSP severely limited by the pension adjustment.

Similarly, Canadians who don't have any earned income or who are over 71 may find the TFSA a useful way to sock away extra funds for retirement on a tax-free basis.

## Education planning (TFSAs or RESPs?)

While the RESP may be the ideal vehicle for most parents who wish to save money for their kids' post-secondary level education due to

the generous federal, and in some provinces provincial, incentive grant and bond programs, they are no longer the only option.

A TFSA will allow a parent to save not only to fund their children's post-secondary education but also for private, primary school education. In addition, when the earnings on the funds invested in the TFSA are withdrawn to fund the children's education, they come out completely tax-free.

Compare that to RESP income withdrawals which generally come out in the form of fully taxable Educational Assistance Payments (EAP). While EAPs are taxable to the student, if she has a part-time job or works during the summer, chances are there may be some tax arising on the EAPs, whereas the TFSA withdrawals can be made by a parent tax-free and then given to the student to fund her education.

## Income splitting with spouse and kids (over 18)

Normally, the attribution rules contained in the Income Tax Act block attempts at splitting either income or capital gains between spouses or partners by attributing such income or gains back to the original spouse or partner.

The new TFSA rules provide a specific exception to the attribution rules, stating that the rules will not apply to any income or gains earned in a TFSA derived from a spouse or partner's gift to the TFSA Holder which the TFSA Holder contributes to his or her TFSA.

This provides a significant opportunity for a high income spouse or partner to give up to \$5,000 to a lower income or zero income spouse or partner to contribute to their own TFSA, thus effectively utilizing the couple's combined \$10,000 per year tax-free contribution limit.

Also, if you've got kids who are at least 18 years of age, you can consider giving them each \$5,000 annually to contribute to their own TFSAs. (You cannot set up a TFSA jointly or "in trust" for a child.)

## Estate planning

The fair market value of the TFSA on the date of death will be received by the estate on a tax-free basis, but any income or gains accruing after the date of death will be taxable.

Individuals ultimately will be able to name a surviving spouse or partner as a “successor holder,” in which case the TFSA will continue to be tax exempt. Alternatively, the date of death value of the assets of a deceased individual’s TFSA can be transferred to a surviving spouse or partner’s TFSA without affecting the surviving spouse or partner’s own existing TFSA contribution room.

At the time of writing, the ability to designate a beneficiary on a TFSA, including designating a successor holder, is not yet possible as it is governed by provincial legislation which would need to be amended to permit such a designation. Should this ultimately be allowed by the provinces, it would have the added benefit of allowing the proceeds from the TFSA to bypass the estate and flow directly to the named beneficiary, avoiding costly probate taxes, where provincially applicable.

## Emigration (non-resident) planning

If you emigrate from Canada and become a non-resident, you can still hold your TFSA and

continue to benefit from the tax exemption on investment income and withdrawals, however, no contributions will be permitted (without penalty taxes arising) nor will TFSA contribution room continue to accrue.

Keep in mind, however, that the other country won’t recognize the tax-free status of the TFSA and therefore, will likely tax the account in accordance with its normal rules for investment accounts.

As with all planning strategies, you should seek the advice of a qualified financial planner or tax advisor to discuss how a TFSA could complement your existing saving and investment plans.

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