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All you Need to Know about Tax Free Savings Account (TFSA)

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Intended Audience

Individuals looking for different saving options with the goal of sheltering tax on earned investment income.

Summary Points to Take Away

- Benefits of a TFSA: (1) Income Splitting Opportunities (2) Tax Free Income and Withdrawals (3) Flexibility of Investment Options (4) Indefinite Carry-Forward of Contribution Room (5) No Income Requirement for Eligibility.
- TFSA's are different than Registered Retirement Savings Plan (RRSP's) in the following ways: (1) Contribution room for RRSP's is a function of the individual's earned income; as compared to TFSA's which are the same amongst all Canadians (2) Withdrawals from an RRSP are fully taxable, unlike those from a TFSA which aren't. (3) Contributions to an RRSP are deductible from taxable income in the year of the contribution, while for TFSA contributions are not tax deductible.

What is a Tax Free Savings Account (TFSA)?

Overview

A Tax Free Savings Account (TFSA) is a savings tool new to Canadians starting 2009. All investment income generated in the account is not subjected to tax. The contribution limit for 2009 is \$5,000, which can be carried forward indefinitely.

Eligibility

Any Canadian resident age 18 or older with a Social Insurance Number can open a TFSA.

Why Take Advantage of a TFSA?

Income Splitting Opportunities

TFSA allows for income splitting opportunities between higher and lower income spouses given that attribution rules do not apply for income earned within the account. When considering the eligibility rules stated earlier (that the contribution room is not based on earned income) in theory a stay at home spouse could have the income earner of the family contribute toward both their TFSA and towards that of the stay at home spouse, with the end result being a lower family tax bill. This is an effective tax splitting strategy as long as each spouse has a different marginal tax rate (which is the case for most families) as it involves taking more taxable investment income out of the higher income spouse's hands.

Tax Free Income and Withdrawals

Earnings from investments in a TFSA, whether it is interest, dividends or capital gains are never subject to Canadian tax. Taxes aren't paid even upon withdraw from the account. This is unlike RRSP's, which only allows for the deferral of tax as the individual is ultimately taxed upon withdrawal. The TFSA doesn't defer tax on investment income; it eliminates it, which is one advantage it has over RRSP's.

Flexibility of Investment Options

Qualified investments for a TFSA include most financial products such as: Saving Accounts, GICs, Mutual Funds, Stocks, and Bonds or a mix of all or some of these various investment vehicles. Allowing for all these options makes a TFSA appropriate for almost everyone as these options cover off the majority of investment products that average individual sinks their savings into. In addition there is no foreign content restriction on the selection of investments such as pre 2005 RRSPs had.

Indefinite Carry forward of Contribution Room

TFSA contribution room is carry forwarded indefinitely; thus, individuals can contribute when cash becomes available. The available contribution room will be tracked by CRA and outlined on an individual's notice of assessment received after the filing of their personal tax return. Withdrawals from their TFSA are also added to the available unused contribution room starting the following year.

No Income Requirement for Eligibility

You don't need to have earned income to contribute to a TFSA. This is extremely beneficial for retirees and stay at home spouses. As well, there is no claw back on the TFSA contribution room for higher income individuals, anyone who meets eligibility requirements is entitled to the same contribution room (which for 2009 is \$5k, indexed to inflation – increases in \$500 increments) regardless if your earned income is \$0 or \$150k.

How it Compares to RRSPs

	RRSP (Retirement Savings Plan)	TFSA (Tax Free Savings Account)
Contribution Room	18% of previous year's earned income (less any pension adjustment), up to the maximum annual RRSP contribution limit for the year set by the CRA (2008's limit is \$20,000)	\$5,000 for 2009, which is indexed to inflation from that point forward.
Eligibility	Individuals with earned income (see above)	Any Canadian resident 18 years of age or older. Regardless of whether he or she is an income earner or not.
Withdrawals – Tax Impact	All withdrawals are added to an individual's taxable income and subject to tax. Depending on the level of the withdrawal – a withholding tax (i.e. taxed in advance, so the individual receives the net upon withdrawal) is applied.	No taxable income generated upon withdrawal.
Investment Income – Tax Impact	Tax is deferred – as mentioned above, withdrawals from an RRSP plan is added to an individual's taxable income.	Tax isn't deferred – it is eliminated as withdrawals are not taxable (see above).
Contributions – Tax Impact	Contributions made during the year within the maximum contribution room are deductible from taxable income in the year of the contribution.	Contributions aren't deductible from taxable income; merely the investment income earned is sheltered from taxes.

Other Points

If you make a TFSA contribution beyond the maximum allowable amount it is considered an over-contribution. The CRA will assess a penalty of 1% per month on your excess contribution. Similar rules apply for an RRSP as well – though there is a \$2K permitted over-contribution level before penalties apply.

Given that investment income and capital gains within a TFSA are not taxed, any capital losses generated in the account can't be used against taxable gains outside the account.

Where to go from here?

Remember the longer an individual's investments are in a TFSA, the faster they'll grow as the tax free income will compound at a higher rate. An RRSP is primarily intended for retirement. The TFSA is like an RRSP for everything else people save for (i.e. savings for short term purchases, supplemental long term income, tax shelter against investment income earned outside of an RRSP, etc). Put your highest taxable investments in your TFSA (i.e. if own shares of BCE and GICs outside of a TFSA, ensure you place the GIC's into the account first since it produces interest income which is 100% taxable as oppose to investment gains from BCE, which would be made up of dividends and capital gains, which are both taxed at a lower level than interest income).

Would love to hear your feedback – contact thatstockguy.NET@gmail.com .

Thanks,

Simon

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