TFSA – Tax Free Savings Account

Over the coming weeks and months you will hear a lot about TFSA, Canada's new Tax-Free Savings Account. There will be advertising and promotion from financial institutions that will rival the Holiday Season and RRSP's. This has in fact already begun, even though the Tax Free Savings Account plan does not come into effect until January 1, 2009.

TFSA will become a part of the Canadian language, "eh"!

The Basics

Beginning in 2009, Canadian residents age 18 and older will be able to deposit up to $5,000 annually to their individual Tax Free Savings Account. This "contribution room" will be indexed to the Consumer Price Index annually and rounded to the closest $500 increment. It is important to note that, unlike an RRSP contribution, a TFSA contribution is not deductible on the individual's tax return.

Investment income earned within the TFSA is earned Tax Free, forever. Regardless of the type of investment income earned, whether it is interest, dividends or capital gains, the income will never be included in your income tax return.

You will be able to withdraw from your TFSA at any time, for any reason. The amount withdrawn will not be subject to income taxes and will not be applied against any federal income-tested credits you may be entitled to such as Old Age Security, Guaranteed Income Supplement or Goods & Services rebates.

Unlike RRSP's, a withdrawal from your TFSA will not reduce or "burn-up" your contribution room. The room is yours and you will be able to replace the contribution at a later date; again, with no income taxes or penalties.

The Canadian Government has also realized that Canadian families often plain and save as a family. Therefore, attribution rules that have created difficulties in tax planning do not apply to the TFSA. A working spouse will be able to give the funds to the lower income or non-working spouse to contribute to their own TFSA without triggering tax consequences.

The Benefits

The TFSA, properly used, will benefit virtually every Canadian and could over time, become the retirement savings vehicle of choice. Canadians with below-average incomes will use the TFSA to avoid taxation on modest withdrawals from their RRSP after reaching age 65 by using the TFSA as a post retirement tax shelter.

When an emergency arises and cash is needed quickly, one of the last things an individual considers in the tax implications. The TFSA will allow for withdrawal and access to emergency funds without the worry of the tax factor.

TFSAs can also be used as collateral against loans. This will allow the individual to borrow funds against the TFSA for other investments, to start a new business or any other reason.

The TFSA account can also be used to supplement Registered Education Savings Plans. While the individual will not receive the government grant portion, the investment income is tax-free.

Attribution rules normally associated between spouses and other family members to not apply to the TFSA. A high wealth individual could supply the funds for their spouse, parents, in-laws and children aged 18 and over without tax consequences.

The Differences

In order to best show the difference between a TFSA and an RRSP let's assume that one contribution of $5,000 is left alone for 30 years with a rate of return of 5.5%. Let's further assume a combined federal/provincial marginal tax rate of 40%.

	TFSA	RRSP
Income Before Taxes	$5,000.00	$5,000.00
Tax paid in year of deposit	2,000.00	-
Net Deposit	3,000.00	5,000.00
Value in 30 years	14,951.85	24,919.76
Tax on Withdrawal	-	9,967.90
Cash in the pocket	$14,951.85	$14,951.85

While a TFSA and an RRSP with all things being equal, will net out to the same amount, the TFSA will offer much more flexibility by allowing the taxpayer to withdraw and replace their contributions during the period.

Taxable Savings vs. the TFSA are outlined on the CRA website and show that an individual contributing $200 per month to a TFSA could save as much as $11,045 in income tax.

The Mechanics

Even though a TFSA will allow a contribution of $5,000, this does not mean that it has to be $5,000. Nor does it mean that the amount needs to be deposited all at once. An individual could begin his or her tax-free savings by depositing each payday or monthly. In fact, a taxpayer who does not contribute to their TFSA say, until 2012, will be able to deposit the full $20,000 at once.

Consider this, a taxpayer contributes to their RRSP and then uses the tax refund generated to contribute to their TFSA. Not only is the RRSP investment income tax sheltered until withdrawal, the TFSA investment income is tax sheltered forever!

The Restrictions

All good things come with some restrictions, although in this case there are very few. First you must be a Canadian resident aged 18 or older. You are also required to file a tax return each year in order to "activate" your contributory room.

Investments that can be held within the TFSA are restricted to the same types of investments within an RRSP.

It is the taxpayer's responsibility to insure that they do not over-contribute to their TFSA. CRA will be tracking TFSA contributory room much as they do now for RRSP. Therefore over-contributions are subjected to a 12% "tax penalty" calculated at 1% per month for each month the taxpayer is over-contributed.

Malcolm Hamilton of Mercer Pension Consultants states that the TFSA is "arguably the most significant change to Canada's saving system since the introduction of RRSPs in 1957."

When you consider the flexibility combined with the tax-free status of the savings vehicle, I don't think anyone can argue against the benefits that will materialize for Canadians using their Tax Free Savings Account.