Tax-Free Saving Account Strategies

The Tax-Free Savings Account (TFSA) was introduced in the 2008 federal budget and was launched January 2009. Canadian residents who are 18 years of age or over were originally permitted to contribute up to $5,000 per year. The annual TFSA contribution limit from 2009 to 2012 was $5,000 and is $5,500 for 2013. The contribution limit is indexed to inflation and is subject to change by the federal government.

While contributions are not tax deductible, income and growth as well as withdrawals from the plan are not taxable. Amounts withdrawn are added back to contribution room in the following year and unused contribution room can be carried forward indefinitely.

This article evaluates alternative strategies using the TFSA.

Saving for Retirement

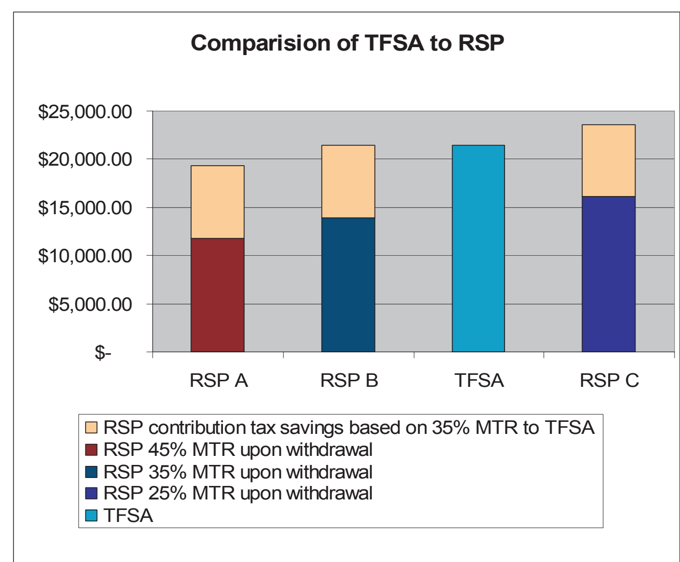
How does the TFSA fit into your retirement saving strategy? Is it preferable to contribute to a Registered Retirement Savings Plan (RSP) or a TFSA?

Since these plans are not mutually exclusive you should consider contributing to both, if you have the financial resources. If you have limited financial resources and you have to choose between contributing to either a RSP or a TFSA, what factors should you consider?

1) The first issue to consider is: which of these plans will generate a higher after-tax income when the funds are withdrawn?

The following chart compares the growth of three one-time $5,000 RSP investments (A, B, C) each assuming a different marginal tax rate (MTR) at the time of withdrawal, each of which generates a tax savings of $1,750 (based on a 35% MTR) which is invested into a TFSA, and a one-time $5,000 TFSA investment. The following assumptions are made:

- Each of these investments earns an annual rate of return of 6%.
- After 25 years, the full value of each investment is withdrawn. The RSPs are withdrawn based on the following marginal tax rates: RSP A - 45%, RSP B - 35% and RSP C – 25%. The TFSA is withdrawn tax free.



Source: TD Waterhouse Products & Services

The preceding illustration shows that:

- Where the current tax rate is higher than the tax rate at the time of withdrawal, the RSP strategy will produce a higher after-tax income. Conversely, where the tax rate at the time of withdrawal is higher than the current tax rate, the TFSA strategy will produce a higher after-tax income.
- Where the tax rate is the same at the time of contribution and withdrawal, the RSP and TFSA strategy will produce the same after-tax income. In

this scenario, the TFSA strategy may be more advantageous because TFSA income does not affect your federal income-tested government benefits such as Old Age Security (OAS), the Guaranteed Income Supplement (GIS) and the Age Credit.

2) Other factors to consider when determining whether to contribute to an RSP or a TFSA:

- If you anticipate that you will need to access the funds on a repeated basis rather than just for retirement, the TFSA may be a better choice. TFSA withdrawals will not increase your tax liability and amounts withdrawn can be re-contributed.

- RSPs and Registered Retirement Income Funds (RIFs) are creditor protected in the event of bankruptcy (except for contributions made in the previous 12 months), but not the TFSA.

Holding Emergency Funds

The TFSA may be an ideal investment vehicle in which to hold your emergency savings.

While it is commonly acknowledged that it is prudent to set aside three to six months of living expenses in liquid investments in a "rainy day" fund to cover any potential financial emergencies, many people are reluctant to do so, opting instead to set up a line of credit. This is mainly because the idea of receiving a low return rate that is then taxed at the marginal tax rate is unappealing to most people. The TFSA may resolve this dilemma, since neither the investment income within the TFSA nor TFSA withdrawals are taxed.

Income Splitting with Your Family

Since income attribution rules do not apply to the TFSA, the higher-income spouse can gift funds to the lower-income spouse to contribute to a TFSA.

Parents and grandparents can also gift funds to an adult child or grandchild to contribute to a TFSA. These funds can be withdrawn tax-free in the future to fund higher education costs, purchase a first home or for other expenditures.

Creating a Tax-Free Legacy

If you are a retiree and you receive more RIF or pension income than you require to meet your lifestyle needs, you can contribute the excess to the TFSA and benefit from the continued tax-free growth of your investments. The funds accumulated in the TFSA can be withdrawn tax-free at a later date to enhance your retirement lifestyle.

Alternatively, if the funds in the TFSA are not required for your retirement needs, you may be able to provide a tax-free legacy to your heirs. This could be a consideration of significant importance especially if you do not have a spouse to whom you can transfer your investments on a rollover basis at death.

Many individuals who are not currently in high tax brackets but possess large RSP or RIF portfolios are concerned about having a significant portion of their RSP/RIF taxed at the highest tax rate on death. A common strategy utilized by them is to increase their current RSP/RIF withdrawal so that the income can be taxed at a lower rate.

A drawback of this strategy is that, if the additional income is not required for lifestyle needs, it will generally be reinvested in a non-registered account where the earnings will be subject to tax. If, instead, this additional income is reinvested in a TFSA, the funds will grow on a tax-free basis.

Paying Down Mortgage vs. TFSA

If you are a homeowner with an outstanding mortgage balance, the question that is often posed is "Should I contribute to my RSP or pay down my mortgage first?" In many instances, the answer tends to be: make your RSP contribution to create a tax refund, and use those funds to pay down the mortgage. With the introduction of the TFSA, you may now wonder whether it is preferable to use the tax refund to contribute to a TFSA or to pay down the mortgage.

In most cases, the general rule is typically to pay down personal debts first, especially if your investment rate of return is less than the mortgage interest rate. The following additional considerations would also appear to favour repaying your mortgage over making TFSA contributions:

- Paying down the mortgage limits risk by decreasing your debt exposure.

- TFSA contribution room can be carried forward indefinitely so you can always make the contribution after the mortgage has been fully repaid.

Saving for a Down Payment

Many Canadians make use of the Home Buyers' Plan (HBP) to withdraw funds from their RSPs to fund a new home purchase. Is this going to change with the introduction of the TFSA?

The HBP program allows first-time home buyers to withdraw up to $25,000 from their RSP without tax implications to help finance the purchase of a new home. The funds withdrawn from the RSP must be paid back each year over a period of 15 years, and, if a payment is not made in a particular year, it will be included in their income for that year.

The TFSA would appear to be the preferred choice (assuming there are enough savings) because it does not restrict the amount that can be withdrawn, does not specify that funds can only be used for first time home buyers, and does not require repayment of the funds withdrawn.

One instance where the HBP may be preferred is where the individual is in the top tax bracket and wants to benefit from the immediate tax savings of making an RSP contribution and then withdrawing funds a short time later. As previously discussed, an individual at the top tax rate may prefer to contribute to an RSP assuming that the tax rate is lower in the future.

Saving for Education

The Registered Education Savings Plan (RESP) has long been the education savings vehicle of choice, because of the additional government assistance provided by the Canada Education Savings Grant (CESG).

The RESP has some restrictions with respect to the use of the funds as well as the potential for double taxation if the beneficiary does not pursue a post-secondary education; the TFSA on the other hand is completely flexible as to how the funds can be used.

Whether the RESP or the TFSA will produce a higher after-tax amount depends on several factors, including your time horizon, the return rate and the child's tax rate when the funds are withdrawn. While RESP income is taxable in the hands of the child, there will generally be no tax liability because students tend to be in lower marginal tax brackets.

One strategy to consider is contributing just enough to an RESP for each beneficiary to obtain the maximum CESG, and directing any additional contributions to a TFSA.

The following items should be considered by those individuals deciding whether to use the Lifelong Learning Program (LLP) or the TFSA to pay for training or education:

- The LLP lets you withdraw up to $10,000 per year (to a maximum of $20,000 over four years) from your RSP, with no tax implications.
- The funds withdrawn from the RSP must be repaid within 10 years and participants must start to make repayments two years after their last eligible withdrawal, or five years after the first withdrawal, depending on which due date comes first.
- If a payment is not made in a particular year it will be included in income for that year.

While the TFSA may be preferred because it does not impose any restrictions regarding the amounts that can be withdrawn and repayment terms, the LLP may be favoured when an individual wants to benefit from the immediate tax savings of making an RSP contribution and then withdrawing funds a short time later.

Integrating the TFSA into an Investment Plan

With the introduction of the TFSA, you now have a choice of three savings vehicles in which to invest – non-registered (taxable), RSP (tax deferred), and the TFSA (tax-free). If you make use of all three investment accounts, how should your investments be structured to make sure that your overall investment portfolio is tax efficient?

The common practice today is to put interest generating investments such as GICs, bonds and bond mutual funds inside your RSPs/RIFs and capital gains generating investments such as stocks and equity mutual funds in your non-registered accounts as much as possible. This is because interest income is fully taxable and accrued annually (i.e. each year whether you receive the interest or elect to reinvest it) whereas only 50% of capital gains are taxable and included in income when realized.

With the addition of the TFSA, it probably still makes sense in many cases to position the fixed income portion of an investment portfolio inside the RSP/RIF and the equities portion in the non-registered account or TFSA.

Should there be a need to allocate some fixed income investments outside the RSP/RIF, it may be worth considering putting these investments in the TFSA rather than in the non-registered account where possible. This will not only shelter the more heavily taxed interest income from tax but also, better preserve your ability to make TFSA withdrawals/re-contribute to your TFSA given that fixed income investments are generally less volatile than equity investments.

One additional consideration – for Canadian tax purposes, foreign dividend income is fully taxable (the same as interest income). Therefore, if your investment portfolio consists of both Canadian and foreign equities which generate healthy dividends, you might wish to invest the foreign equities in a TFSA so that the foreign dividend income (which would otherwise be fully taxed) accumulates tax-free inside the TFSA.

Other Considerations

- If you intend to become a non-resident of Canada, you may consider topping up your TFSA contributions prior to becoming a non-resident. Once you cease Canadian residency, any contributions made while you are a non-resident will be subject to a 1% per month special tax until you withdraw the amount and designate it as a withdrawal of a non-resident contribution. In addition, no contribution room will accrue for any year in which you are a non-resident., but your TFSA will continue to grow tax-free for Canadian tax purposes. You should however determine the tax status of the TFSA in your new country of residence by checking with a qualified tax professional in your new jurisdiction. Since Canadian withholding tax is not applied on many types of capital gains and interest payments, from a Canadian tax perspective, a non-resident may consider holding Canadian dividend producing investments inside their TFSA to shelter the dividend payments from Canadian withholding tax.
- If you are a U.S. citizen or green card holder living in Canada, you should consult your professional tax advisor prior to investing in a TFSA. U.S. tax rules may not recognize the tax-free status of the TFSA.
- If you are considering an in-kind contribution to your TFSA, you may not want to transfer a security with accrued loss since you will not be able to claim the loss.
- If you are considering borrowing to invest, you should note that interest is not deductible on funds borrowed to invest to a TFSA. As an alternative, you may wish to borrow to invest in a non-registered account where the interest may be deducted.
- You should consider paying any investment counsel fees associated with your TFSA from outside your TFSA. While investment counsel fees relating to a TFSA cannot be deducted, by paying the fees from outside of the TFSA (which is not considered to be a withdrawal from the TFSA), you can maximize the tax-free growth of the TFSA.

The introduction of the TFSA brought with it many new planning opportunities, some of which have been discussed in this article. As everyone's situation is different, you should consult both your investment and tax advisors to determine how you can make the best use of your TFSA.

Last revised: December 17, 2012

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