Tax-Free Savings Accounts*

By: David Louis, J.D., C.A., Tax Partner.
Minden Gross LLP, a member of MERITAS Law Firms Worldwide.

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The 2008 federal budget[1] introduced the Tax-Free Savings Account (TFSA), available to individuals[2] starting in 2009. Financial institutions currently eligible to issue RRSPs are permitted to issue TFSAs. This includes Canadian trust companies, life insurance companies, banks and credit unions.

An individual who is resident in Canada and 18 years of age or older is eligible to establish a TFSA. An individual can hold more than one TFSA, but will be subject to overall annual contribution limits.[3]

Contribution Room

Starting in 2009, individuals 18 years of age and older acquire $5,000 of TFSA contribution room each calendar year. Starting in 2010, the $5,000 limit will be indexed to inflation and the annual additions to contribution room will be rounded to the nearest $500. Unused contribution room will be carried forward to future years. For example, if an individual contributes $2,000 to a TFSA in 2009, the individual's contribution room for 2010 will be $8,000 ($5,000 for 2010[4] plus $3,000 carried forward from 2009). There is no limit on the number of years that unused contribution room can be carried forward, nor is there a ceiling on aggregate contributions. However, excess contributions are subject to a tax of 1% per cent per month [5].

Any amounts withdrawn from an individual's TFSA in a year – which can be used for any purpose - will be added to his or her contribution room for the following year. This gives individuals who access their TFSA savings the ability to re-contribute an equivalent amount in the future.

The following example shows that the potential contribution to a TFSA can be significantly more than $5,000 annually, and thus the individual can earn more tax-free investment income.

Example

> Suppose that an individual invests his or her $5,000 TFSA contribution in the stock market, and the investments appreciate rapidly to $15,000. The taxpayer can sell the shares, realize the $15,000 tax-free capital gain in the TFSA, and withdraw the cash proceeds tax-free. The $15,000 can be recontributed to the TFSA, in addition to any other unused and current TFSA contribution room, in the following year or later.

The contribution room applies to each individual qualifying for a TFSA, so that spouses will have $10,000 of contribution room for 2009, a cumulative total of $20,000 for 2010, and so on. Adult children, who are eligible for their own plans, can enlarge a family's combined contribution room further.

There is no restriction on a higher-income taxpayer funding a TFSA for his or her spouse (or adult children). If an individual transfers property to a spouse or common-law partner, the "attribution rules" generally treat any income earned on that property as income of the individual. However, an exception normally applies to the attribution rules, which allows individuals to take advantage of the

TFSA contribution room available to them using funds provided by their spouse or common-law partner: the attribution rules will not apply to income earned in a TFSA that is derived from such contributions[6].

It is possible to make "in-kind" contributions to a TFSA, as long as the property is a qualified investment (see below). The amount of the contribution will be equal to the fair market value of the property. The contributor will be considered to have a deemed sale of the transferred property at its fair market value at the time of the contribution. However, if the cost is more than the fair market value, the resulting capital loss will be denied[7].

Tax-Free Amounts

While contributions to a TFSA are not deductible, income, losses and gains in respect of investments held within a TFSA, as well as amounts withdrawn, will not be included in computing income for tax purposes or taken into account in determining eligibility for income-tested benefits or credits delivered through the income tax system (for example, the Canada Child Tax Benefit, the Goods and Services Tax Credit and the Age Credit). Nor will such amounts be taken into account in determining other benefits that are based on the individual's income level, such as Old Age Security benefits, the Guaranteed Income Supplement or Employment Insurance benefits. Because the investment income within, and withdrawals from, a TFSA are not taxable, interest on money borrowed to invest in a TFSA is not deductible[8]. However, unlike RRSPs, a TFSA may usually be used as security for a loan[9].

Death, Marriage Breakdown, Non-Residency

The fair market value of the TFSA on the date of death will be received by the estate tax free. (That is, investment income and gains that accrue in the account after the individual's death will be taxable, while those that accrued before death will remain exempt.) However, an individual will be permitted to name his or her spouse or common-law partner as the successor account holder, in which case the account will maintain its tax-exempt status. Alternatively, the assets of a deceased individual's TFSA may be transferred to a TFSA of the surviving spouse or common-law partner, regardless of whether the survivor has available contribution room, and without reducing the survivor's existing room.[10]

On the breakdown of a marriage or a common-law partnership, an amount may be transferred directly from the TFSA of one party to the relationship to the TFSA of the other. In this circumstance, the transfer will not reinstate contribution room of the transferor, and will not be counted against the contribution room of the transferee.

An individual who becomes non-resident will be allowed to maintain his or her TFSA and continue to benefit from the exemption from tax on investment income and withdrawals. (The “deemed sale” rules do not apply to a TFSA on ceasing to be or becoming a Canadian resident.[11]) No contributions will be permitted while the individual is non-resident[12], and no contribution room will accrue for any year throughout which the individual is non-resident. Unlike RRSPs, TFSA withdrawals by non-residents are usually not subject to withholding tax. Withdrawals are added back to contribution room for the following year, but are available only when the individual resumes Canadian residence.

Reporting

The CRA will determine TFSA contribution room for each eligible individual who files an annual income tax return (on the individual’s Notice of Assessment and through the “My Account” function on the CRA web site). Individuals who have not filed returns for prior years (because, for example, there was no tax payable) will be permitted to establish their entitlement to contribution room by filing a return for those years or by other means acceptable to the CRA. To provide the CRA with adequate means to determine contribution room and monitor compliance, TFSA issuers are required to file annual information returns.

Qualified Investments

A TFSA is generally permitted to hold investments which are quite similar to those allowed for an RRSP.[13] However, the *Income Tax Act* contains provisions designed to penalize individuals whose TFSA holds a “prohibited investment”: generally this refers to investments in any entities with which the account holder does not deal at arm's length, a corporation of which the account holder is a “specified shareholder” as defined in the *Income Tax Act,* or other entity in which the account holder has an analogous interest (“specified shareholder” generally refers to a 10% or greater interest in a class of shares of the corporation or a related corporation, counting the holdings of non-arm's length persons)[14].

It is possible for an RRSP to invest in shares of a private corporation.[15] Likewise, it is possible for a TFSA to do so, within the limitations described above. It should be noted that regulation 4900(12) allows as a qualified investment for an RRSP shares of a “specified small business corporation”[16], provided that the RRSP annuitant is not a “connected shareholder” of the corporation immediately after the acquisition of the share. The connected shareholder definition dovetails with the TFSA requirement because it refers to a person who directly or indirectly holds 10% or more of the shares of any class of the corporation or any corporation related to the corporation. In the case of RRSPs, there is a “safe harbour” rule from the 10% restriction where the person deals at arm's length with the corporation and the cost of the shares in the corporation is less than $25,000; but it does not appear that the safe harbour rules apply to TFSAs. Nevertheless, it may be possible for a TFSA to acquire shares of such a corporation, as long as it retains “specified small business corporation” status[17].

As is the case with RRSPs, individuals should review administrative and withdrawal fees, transaction charges and interest (if any) on cash balances.

Note: If property that is considered to be a prohibited investment or a non-qualified investment is acquired, or if property held in the account becomes such, a tax of 50% of the fair market value of the property, at the time it was acquired or that it became a non-qualified or prohibited investment is payable[18]. When a TFSA holds a prohibited investment, the holder will also be subject to an additional tax that is based on income earned from the prohibited investment.[19]

TFSAs versus RRSPs (etc.) – Investment and Other Considerations

As stated above, individuals and family members will start to accumulate fairly significant TFSA contribution room which, when added to RRSP contribution room, may well be more than accumulating savings. If so, questions will arise as to which vehicle is preferable. In addition, it may be possible to make contributions to an RESP. There is an additional choice of paying down a mortgage or contributing to an RRSP.[20] At first blush, one might think that that an RRSP, which offers an immediate tax write-off, might be superior to a TFSA from an after-tax standpoint. As will be explained shortly, this is generally not the case.

An RRSP is a *tax-deferred* investment vehicle. It offers deductibility for contributions, tax-free accumulation, and withdrawals/retirement benefits which are fully included in income. On the termination of an RRSP, earnings accumulated in the plan are effectively taxable since all amounts received from the RRSP are taxable - this will also recapture the initial deductions for contributions. A TFSA, on the other hand, is a *tax-free* investment vehicle: contributions are made in after-tax dollars; like an RRSP, earnings accumulate tax-free; but unlike an RRSP, there is no tax on withdrawal[21].

The financial comparison between these features appears to be similar to the choice between contributing to an RRSP and paying down a mortgage. Provided that a taxpayer remains in the same marginal tax rate before and after retirement, and the interest paid on the mortgage is the same as the return made by the RRSP, the choice between investing in an RRSP and paying down a mortgage appears to be financially neutral.[22] Whereas the interest on the mortgage versus return in the RRSP is a variable in the mortgage vs. RRSP decision, this is not the case in the TFSA vs. RRSP decision, since similar investments can be made in either vehicle. The remaining variable appears to be tax rates before and after retirement. Assuming these are the same, this results in financial neutrality between TFSAs and RRSPs[23]. Although one might expect tax rates to drop because post-retirement income should generally be lower (which would tip the scales in favour of an RRSP), income-based clawbacks[24] muddy the waters, as they can effectively propel a taxpayer into a higher effective tax rate. (However, RRIF and RRSP annuity payments are eligible for the pension-splitting rules for couples which came into effect in 2007 and may "even out" post-retirement income, perhaps so as to reduce income-based clawbacks.) An RESP is somewhat similar to a TFSA, except that, while contributions are made on an after-tax basis, earnings are potentially taxable to the student (or may reduce tuition and education transfers); however, this effect may be modest and could be more than offset by the ability to obtain CESGs[25].

It should be noted, however, that the financial comparison above between a TFSA and an RRSP assumes that the term of the investment is the same. While an RRSP has mandatory maturity at the end of the year the annuitant turns 71 whereby taxable payouts must commence, there is currently no mandatory maturity for a TFSA, nor is there an age where an individual can no longer contribute. It therefore appears possible for an individual to extend the benefits of tax-free status indefinitely. However, whether this will continue to be the case as the years go by and contributions mount up may be another matter: one cannot eliminate the possibility of future changes to TFSA legislation, e.g., to impose mandatory withdrawals by the elderly, or perhaps even income-based restrictions on contributions[26].

As noted previously, the ability to make a tax-free withdrawal from a TFSA which reinstates contribution room presents an advantage over RRSP withdrawals. In the latter case, such withdrawals are taxable[27], may have an adverse effect on benefits which are based on income, and do not reinstate RRSP contribution room.

It can be seen that seniors, particularly those with low incomes, will benefit from TFSAs because of the lack of impact of withdrawals on income-tested benefits, no age limit for contributions, as well as the fact that, unlike RRSPs, TFSA contributions are not dependent on "earned income". Younger individuals will find tax-free withdrawals and the reinstatement of contribution room to be attractive; however, the lack of tax on withdrawals will remove the psychological barrier – which is present with RRSPs - to retain funds in the plan, e.g., for retirement. (For those in temporary low-tax brackets, consideration should be given to contributing to a TFSA and conserving RRSP contribution limits for higher-income years.)

Also, in these vehicles, tax advantages relating to investments, including capital gains status and the dividend tax credit, are lost. Also lost are the benefits of capital or other tax losses. As is the case with RRSPs, if the investor has capital outside of his or her plan, it may make sense to make tax-advantaged investments personally, and invest high-tax items in either of these plans.[28] If an investor is contemplating a very large shorter-term capital gain (e.g., on an equity investment), the taxable portion of which is likely to be well in excess of returns on fixed income investments, the equity investment could, in effect, become high-tax since the tax has to be paid for the year in which the investment is sold. Holding such investment in a TFSA would make even more sense than in an RRSP since the gain would be entirely tax free, rather than tax-deferred, as is the case with an RRSP.

With rapidly accumulating contribution room in both vehicles, significant non-registered savings may become something of a rarity other than for the wealthy. Generally, passing up contributions to these plans because of the loss of tax advantages is usually not a good idea, unless the taxpayer is in a low bracket.

Finally, for shareholders of closely-held corporations, it should be noted that the ability to earn income on a tax-deferred basis in an RRSP and tax-free basis in a TFSA may put more pressure on making distributions of funds that would otherwise be deployed in corporate-level investments. Although this may result in additional current tax, retaining funds at the corporate level will result in significant tax on investment income. Consideration should therefore be given to ensuring that sufficient funds are distributed to make full contributions to RRSPs[29] and TFSAs.

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[1] For technical articles on TFSAs, reference should be made to "Tax Deferral: Old and New" a paper by Philip Friedlan presented at the 2008 Ontario Tax Conference (unpublished at time of writing) and "Policy Forum: Tax-Free Savings Accounts – A Practitioner's Perspective", Heather Evans, 2008 CTJ No. 3, p. 708.

[2] Other than trusts.

[3] TFSAs can be transferred from one financial institution to another without being considered a withdrawal or contribution; transfer fees may apply.

[4] Ignoring indexing.

[5] Per section 207.02; unlike RRSPs, there is no $2,000 "cushion" on overcontributions.

[6] See subsection 74.5(12)(c); per paragraph 75(3)(a), property held in a TFSA is not subject to subsection 75(2) .

[7] See clause 40(2)(g)(iv)(A).

[8] See subsection 18(11). Like an RRSP, fees for services such as investment counsel or administration fees are not deductible, per paragraph 18(1)(u).

[9] See subsection 146.2(4).

[10] At time of writing, there is ongoing provincial lobbying to amend succession legislation to permit the designation of a successor holder or beneficiary of a TFSA, so that the TFSA can pass outside the estate and avoid probate levies, where applicable. For example, these changes were proposed in the 2009 Ontario Budget (March 26th).

[11] Per subparagraph (a)(iii.2) of "excluded right or interest" definition in subsection 128.1(10).

[12] Per section 207.03, a 1% per month penalty tax applies to non-resident contributions until the contributions are withdrawn or the date when the TFSA holder resumes Canadian residence, if earlier.

[13] Qualified investments for RRSPs are discussed at ¶25,380a of the *Canada Income Tax Guide*.

[14] See definition in subsection 207.01(1); see also subsection 207.01(4). A prohibited investment is any property of a TFSA (other than prescribed excluded property) that is:

- a debt of the holder of the TFSA;
- a share of a capital stock of, an interest in, or a debt of a corporation, partnership or trust in which the holder of the TFSA has a significant interest (generally based on a 10%-or-more holding, counting the holdings of non-arm's length persons; e.g., in the case of a corporation, a 10% or greater interest in the shares of any class of a corporation or a related corporation, counting the holdings of non-arm's length persons);
- a share of a capital stock of, an interest in, or a debt of a person or partnership that does not deal at arm's length with the holder of the TFSA or with a person or partnership in which the holder has "significant interest";
- an interest in, or a right to acquire a share, interest or debt described above;
- property prescribed by regulations.

However, regulation 5000 in Bill C-10 designates as prescribed excluded property (so that prohibited investment status does not apply) NHA-insured mortgages which are a qualified RRSP investment pursuant to regulation 4900(1)(j.1). (For further discussion, reference should be made to the discussion on "Insured Mortgage Loans" at ¶25,380a of the *Canada Income Tax Guide*.)

[15] For further discussion, reference should be made to ¶25,380a of the *Canada Income Tax Guide*.

[16] This is similar to the "small business corporation" requirement, with which most practitioners will be familiar, but rather than requiring CCPC status, per the "small business corporation" definition, the corporation must be a Canadian corporation that is not directly or indirectly controlled by one or more non-residents.

[17] See Regulation 5001, which requires specified small business status to be maintained; otherwise the holding will be a "prohibited investment". It may well be the case that this will be an onerous requirement which could deter such an investment.

[18] See section 207.04. This is usually refundable if the TFSA divests the offside investment by the end of the calendar year following the year in which the penalty tax arose (or such later time as the CRA considers reasonable in the circumstances).

[19] See subsections 207.04(6) and (7). Income includes the actual amount of dividends received (ignoring the dividend tax credit), and the full amount of capital dividends and net capital gains. The tax is 150% of the amount payable under Part I, to ensure that there is no provincial tax advantage. Penalties also apply if a TFSA carries on a business (see subsection 146.2(6)).

Per section 207.05, penalties arise where there is an "advantage" extended to the holder of the TFSA or a non-arm's length person. This includes any benefit, loan, or indebtedness that depends on the existence of the TFSA. (Exceptions include TFSA withdrawals; administrative or investment services in connection with a TFSA; loans and debt on arm's-length terms; and payments or allocations to a TFSA by the issuer.) See in particular paragraph (b) of the definition of "advantage" in subsection 207.01(1), which pertains to increases in the fair market value of property held by a TFSA attributable to "artificial" circumstances, e.g., transactions that would not have occurred in an open market with arm's length parties designed to exploit the exemption for TFSAs, or shift income from the TFSA holder or non-arm's-length persons. The penalty equals the fair market value of the benefit and/or the amount of the loan or indebtedness.

Most penalties noted herein may be waived by the CRA. For further discussion of TFSA penalty taxes, see "TFSA Penalties and Tax", Ken Griffen and Louis Provenzano, *Canadian Tax Highlights*, January, 2009.

[20] For further discussion, reference should be made to ¶25,351 of the *Canada Income Tax Guide*.

[21] There are no mechanisms for tax-free transfers to a TFSA from an RRSP or other deferred income plans.

[22] For further discussion, reference should be made to ¶25,351 of the *Canada Income Tax Guide*.

[23] I.e., if the same contribution were made to each plan on an after-tax basis, so that all tax savings from an RRSP were used to enlarge the contribution itself. This was pointed out in the 2008 Federal Budget Papers themselves - see the table entitled "Net Proceeds From Saving in a TFSA Relative to Other Savings Vehicles", in Annex 4 of the Budget Papers.

[24] I.e., in respect of OAS, GIS and the age credit.

[25] Of course, a TFSA cannot be held by a minor.

[26] At time of writing, this is completely speculative.

[27] An exception is the first time home buyers' plan (as well as the lifelong learning plan). In this case, however, to avoid tax, the withdrawal must be repaid in equal installments over 15 years; in addition, the benefits are restricted to "first time" home buyers (as defined). With a TFSA, there is time no required repayment (the withdrawal increases TFSA contribution room so that the TFSA can later be replenished); of course, there is no requirement to be a "first time" home buyer. The first time home buyers' plan imposes a $25,000-per-individual ceiling on withdrawals.

[28] For further discussion, reference should be made to ¶25,335 of the *Canada Income Tax Guide.*

[29] In this case, usually by way of salary/bonus.