The Tax-Free Savings Account

Good for pre-retirement and retirement

A Tax-Free Savings Account (TFSA) is a flexible investment account that you can use to meet short and long-term goals. Assets held inside a TFSA can earn interest, dividends or capital gains, but this income is not taxed, even when amounts are withdrawn from the TFSA, unlike a Registered Retirement Savings Plan (RRSP). Therefore, a TFSA can be used for both retirement and pre-retirement goals.

Unlike an RRSP, a TFSA does not have to be converted to RRIF by the end of the year you turn 71. You can continue to contribute to a TFSA and take advantage of tax-free growth inside it for the rest of your life.

In most provinces you can open a TFSA when you turn 18, as long as you have a Social Insurance Number. Even if your birthday is late in the year, you will be allowed to contribute up to your full contribution limit that year. However, if you live in British Columbia, Newfoundland and Labrador, Nova Scotia or New Brunswick where the age of majority is 19, then you will need to wait until you are 19 before you can open a TFSA.

The initial limit that could be contributed to a TFSA when this savings vehicle was introduced in 2009 was $5,000. It remained $5,000 through the 2012 tax year. In the ensuing years the TFSA dollar limit fluctuated as follows:

- $5,500 in 2013, 2014
- $10,000 in 2015
- $5,500 in 2016, 2017, 2018
- $6,000 in 2019, 2020

The cumulative limit in 2020 will be $69,500 for a Canadian who was 18 or older in 2009 and has never contributed to a TFSA. You can find out your individual contribution room by setting up “My Account” on the Canada Revenue Agency website, or installing the MyCRA mobile app on your mobile device.

If you don’t contribute fully to your TFSA in any given year, the unused contribution room can be carried forward indefinitely.

A TFSA allows for the purchase of similar qualified investments as an RRSP such as stocks, bonds and mutual funds. You can have more than one TFSA if you like, as long as you don’t exceed your total annual contribution room. If you do, the excess will be taxed at 1% — on the highest excess TFSA amount each month — until the excess is withdrawn or subsequently absorbed into unused contribution room in a future year. You can transfer to another or a new TFSA as long as the funds are directly transferred between accounts.

Tax Treatment of a TFSA

If at some point you become a non-resident of Canada, you will be subject to departure tax rules, which deem you to have disposed of all your property and reacquire it, creating a tax liability. However, certain assets are excluded from these rules, including TFSAs and other registered plans.

You can contribute to your TFSA up to the date your residency status changes. You can also continue to benefit under Canadian tax law from the tax-free treatment of the investments when you are a non-resident. You will not accrue new contribution room while you remain a non-resident. If you make new contributions, those funds will be taxed 1% for every month they stay in the account, in addition to a 1% penalty for each month any excess contributions remain in the account.

There are a few key differences between an RRSP and a TFSA. With an RRSP, contributions will reduce your taxes payable in the year the contributions are made. Your contributions and investments held in the plan can grow tax-deferred, but upon withdrawal, you will be taxed.

With a TFSA, you do not get a tax deduction for making a contribution, so you are contributing with after-tax income. You do get the benefit of tax-free income from any investment held within the vehicle. Crucially, when you withdraw the income you will not be taxed.

> Withdrawals create new TFSA contribution room in the following year.

Finally, when you use up your RRSP contribution room, it can’t be recovered. That’s not true for a TFSA. A withdrawal (except withdrawals of excess amounts) creates new TFSA contribution room in the following year. Perhaps you want to withdraw money from your TFSA to make a down-payment on a house, assist in funding your child’s university education, or any personal reason that you choose. This easy accessibility can be an attractive feature of a TFSA.

On the other hand, you may wish to keep the TFSA well into retirement as a source of non-taxable income.

Other uses of a TFSA

Since withdrawals from a TFSA are not taxed, your TFSA can be used as collateral for a loan or line of credit. You can’t do that with your RRSP. If you did, your RRSP would be taxed.

There are no spousal TFSAs, however you can give your spouse or common-law partner funds to contribute to

their TFSA. Any income your spouse earns in their TFSA is theirs and generally will not be attributed back to you.

If your marriage or common-law partnership breaks down, any TFSA amount can be transferred from one partner to the other on a tax-free basis. Official documentation, such as a separation agreement or divorce decree, is required to permit a tax-exempt transfer to facilitate the settlement of property equalization or support. It should be noted that a transfer does not affect the recipient's contribution room.

The "superficial loss rules" are relevant to TFSAs. These rules apply to defer recognition of a loss you incur by disposing of capital property when that property, or identical property (e.g., a particular stock) is purchased or repurchased by you, or an affiliated person, 30 days before or after the sale. A TFSA of which you are a beneficiary will generally be considered to be an affiliated person for the purpose of this rule.

One of the biggest benefits that a TFSA has over an RRSP is that funds withdrawn from a TFSA are not taxable income. As a result, such withdrawals do not have an impact on income-tested benefits such as Old Age security and Guaranteed Income Supplement or tax credits such as the Age credit.

Your tax rate will be pivotal in considering whether to contribute to an RRSP or TFSA. If your tax rate in retirement will be lower when you withdraw funds from a registered plan than when you contributed them, the RRSP may be a better focus. However, another way to look at the issue is consider using your RRSP for your retirement needs and a TFSA for supplemental retirement income needs.

Talk with your TD advisor about the multiple uses of a TFSA. Can you afford to contribute the maximum amounts to an RRSP and a TFSA? Given the differences between the two vehicles and the tax implications, your advisor can help you decide where to direct your contributions in the context of your overall retirement plan.

Calculating your TFSA contribution room: an example

Your TFSA contribution room consists of:

- Your current year TFSA dollar limit;
- any unused TSFA contribution room from previous years; and,
- Any withdrawals made from the TFSA in the previous year.

Let's look at an example:

From 2009 until the end of 2018, Jacob contributed the maximum TFSA dollar limit each year. He did not make any withdrawals during the period of 2009-2018. His TFSA contribution room at the beginning of 2019 was $6,000 (the 2019 TFSA dollar limit).

On June 15th, 2019, Jacob made a contribution of $500. On October 26th, 2019, he withdrew $4,000. His unused TFSA contribution room at the end of 2019 was $5,500 ($6,000 - $500). Jacob will make the following calculation to determine his TFSA contribution room at the beginning of 2020:

Step 1: Unused TFSA contribution room at the end of 2019

TFSA contribution room at the beginning of 2019 ($6,000) minus contributions made in 2019 ($500) = Unused TFSA contribution room at the end of 2019 ($5,500).

Step 2: TFSA contribution room at the beginning of 2020

Unused TFSA contribution room at the end of 2019 ($5,500) + total withdrawals made in 2019 ($4,000) + 2020 TFSA dollar limit ($6,000) = TFSA contribution room at the beginning of 2020 ($15,500).

Passing on your TFSA

You are permitted to name a "successor holder" or beneficiary of your TFSA, who will inherit it at the time of your death. This can happen in the TFSA contract or in your Will (except in Quebec where it can only be done in the Will).

The successor holder will be either your spouse or common-law partner. Anyone else would be a beneficiary.

After your death, the TFSA continues to exist. Both its value and income earned after the date of death continues to be tax-free for the successor holder. The successor holder does not require unused contribution room to facilitate the transfer. However, if your TFSA is in an over-contribution position when you die, your successor will need unused room, or have to pay over-contribution penalties.

Where your spouse or common-law partner is named as a beneficiary (as opposed to a successor holder), he or she is considered a survivor. A survivor can transfer the funds in your TFSA into their own TFSA and designate this transfer as an "exempt contribution". This must be done between the date of death and December 31st in the year following the year of your death. The amount of the exempt contribution cannot generally exceed the value of the plan as of the date of death. Any funds that accrue in the plan after death would require your survivor to have contribution room. The growth between the date of death and the date of receipt by the survivor will be taxed.

Anyone other than a spouse or common-law partner that has been designated as a beneficiary will acquire the rights to your TFSA funds, but they will need TFSA contribution room in order to keep the proceeds sheltered within a TFSA. They will not have the ability to designate an exempt contribution. They will also be taxed on any growth in your TFSA between the date of your death and the date they receive the funds.

If you do not name a successor holder, or designate a beneficiary, the fair market value of the TFSA will paid tax-free to your estate. Any income that accrues after the transfer will be taxable to your estate.

If you have questions about passing on your TFSA, speak with your TD advisor.

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