

Tax Memo

Tax-Free Savings Account – A Good Way to Save

Commencing 2009, Canadians can contribute to a new savings vehicle, the Tax-Free Savings Account (TFSA). You can use TFSAs to save for any purpose, including retirement, buying a home, starting a small business and taking a vacation. The merits of the TFSA make it a high-priority investment option, in addition to contributing to your Registered Retirement Savings Plans (RRSPs) and paying down a mortgage on your principal residence.

The TFSA was introduced in the 2008 federal budget and implemented by Bill C-50¹, which received royal assent on June 18, 2008. The rules were refined initially by draft legislation released on July 14, 2008, and subsequently by a Notice of Ways and Means Motion released on November 28, 2008. This *Tax Memo* discusses the TFSA rules and how a TFSA can benefit you. It covers the following topics:

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TFSAs – The Basics

Beginning January 2009, Canadian residents aged 18 years and older who have a Social Insurance Number can contribute up to \$5,000 each year (to be indexed) to a TFSA. TFSAs will be widely available at financial institutions and will generally be structured as trusts or deposits. The investments that a TFSA can make are similar to those that can be made by an RRSP.

¹ Bill C-50, *An Act to implement certain provisions of the budget tabled in Parliament on February 26, 2008 and to enact provisions to preserve the fiscal plan set out in that budget.*

Contributions to a TFSA are not tax-deductible and income (including capital gains) earned in a TFSA is exempt from income tax. Withdrawals from a TFSA (whether from capital or income) are tax-free and will increase your contribution room in future years. Furthermore, if you contribute less than the annual contribution limit (\$5,000 for 2009), the unused contribution room can be carried forward indefinitely.

Because income earned in a TFSA is exempt from tax, interest on money you borrow to contribute to a TFSA will not be deductible for tax purposes.

Why Open a TFSA?

TFSA's are attractive for several reasons:

- Tax-free earnings – Income earned in a TFSA is not taxable, allowing you to grow funds faster than if invested outside of a TFSA.
- Contribution room is not lost on withdrawal – Amounts withdrawn from your TFSA will be added to your unused contribution room for future years.
- Income splitting – If you give funds to your spouse and/or other adult family members to contribute to a TFSA, the income earned in their TFSAs will not be taxable to you.
- Post-age 71 contributions – You can contribute to a TFSA after you turn 71, even though this is when you must wind up your RRSP.
- Income-tested benefits – Neither earnings in a TFSA nor withdrawals will affect income-tested federal government benefits, such as Old Age Security, the Working Income Tax Benefit, the GST/HST tax credit, the Canada Child Tax Benefit and Employment Insurance benefits.
- Loan collateral – You can use a TFSA as collateral for a loan or other indebtedness, if certain criteria are met.

Contributing to a TFSA

Contributions to your TFSA cannot exceed your contribution room for the year, which is calculated as follows:

Table 1 — TFSA Contribution Room

A	Annual contribution limit for the year ¹
B +	Withdrawals made in the previous year ²
C +	Unused contribution room from the previous year
D =	Contribution room for the year

1. The annual contribution limit for 2009 is \$5,000. It will be indexed after 2009, rounded to the nearest \$500.
2. Other than qualifying transfers, which are:
 - direct transfers between TFSAs of the same holder; or
 - amounts transferred between spouses or common-law partners upon marital breakdown (see **TFSAs and Marital Breakdown** on page 4).

Example – TFSA Contribution Room

Transactions in a taxpayer's TFSA:

	2009	2010	2011
TFSA start of year	Nil	\$900	\$6,000
TFSA contributions	\$5,000	\$4,600	\$5,500
Income/(loss)	(\$3,500)	\$500	\$20,000
TFSA withdrawals	(\$600)	Nil	(\$30,000)
TFSA end of year	\$900	\$6,000	\$1,500

Result: TFSA contribution room:

	2009	2010	2011	2012
A¹	\$5,000	\$5,000	\$5,000	\$5,000
B +	N/A	\$600	Nil	\$30,000
C +	N/A	Nil ²	\$1,000 ²	\$500 ²
D =	\$5,000	\$5,600	\$6,000	\$35,500

1. Assumes annual contribution limit remains \$5,000 after 2009.
2. The unused contribution room from the previous year is:

	2010	2011	2012
Previous year's Contribution room (D)	\$5,000	\$5,600	\$6,000
Previous year's TFSA contributions (see above)	(\$5,000)	(\$4,600)	(\$5,500)
Previous year's Unused contribution room (C)	Nil	\$1,000	\$500

The Canada Revenue Agency will advise you of your contribution room on your Notice of Assessment. Individuals with no tax payable should file T1 income tax returns to establish their contribution room entitlement.

You can set up more than one TFSA; however, your contributions to all of your TFSAs cannot exceed your TFSA contribution room. As explained in the Appendix, if you overcontribute to your TFSAs, you will be liable for a monthly 1% penalty tax on the excess contributions. This tax will apply until the excess contributions are withdrawn or new contribution room earned in subsequent years eliminates the excess contribution.

In-kind contributions

You can make in-kind contributions of qualifying investments to your TFSA (see **Qualifying Investments** below). The amount of the contribution will be equal to the fair market value of the property at the time of the contribution, and you will be considered to have disposed of the property for this amount. Any resulting gain will generally be taxable, but a capital loss will be disallowed for tax purposes.

TFSA services fees

Services fees you pay relating to your TFSA are not deductible for tax purposes and will not constitute a contribution to the TFSA. Further, investment counsel fees that are paid by a TFSA will not be considered a withdrawal from the TFSA, and therefore will not increase your contribution room.

Qualifying Investments

A TFSA can make essentially the same types of investments as an RRSP. Qualifying investments include:

- money and deposits;
- guaranteed investment certificates (GICs);
- federal, provincial and municipal bonds and debts (those of a Crown corporation also qualify);
- public company bonds and debts;
- shares listed on prescribed stock exchanges in Canada or in a foreign country;
- annuities;
- units or shares of mutual funds;
- segregated fund policies;
- certain mortgages; and
- certain shares of small business corporations.

Investments that cannot be held by a TFSA are considered to be “non-qualifying” and/or “prohibited” (see **Prohibited Investments** below) investments, to which penalty taxes apply (see the Appendix). Income earned from non-qualifying investments will be subject to tax (see Table 2).

Prohibited investments

TFSA's are specifically prohibited from investing in certain types of investments, including:

- loans to the TFSA holder; and
- shares or debt of a corporation, partnership or trust in which the TFSA holder and/or non-arm's length persons have a significant interest (generally, 10% or more).

TFSA income subject to tax

The taxation of TFSA income is outlined in the following table.

Table 2 — Taxation of TFSA income

		Treatment for tax purposes	Who pays tax
Source of income	Qualifying investments	Exempt from tax	N/A
	Prohibited investments ¹	Additional penalty tax applies — see the Appendix	TFSA holder
	Non-qualifying investments ¹	The TFSA trust is taxed at the top personal income tax rate.	TFSA
	Carrying on a business ²	Income subject to tax from these investments includes: <ul style="list-style-type: none"> • capital dividends (these are fully taxable); and • the full amount of capital gains, net of capital losses (the 50% inclusion rate does not apply). 	

1. An investment that is both non-qualifying and prohibited will be deemed to be a prohibited investment only.
2. The tax effectively prevents a TFSA from carrying on a business.

Death of TFSA holder

Your TFSA will maintain its tax-exempt status after your death if your spouse or common-law partner is named as the sole successor TFSA-holder. Otherwise, a trustee TFSA will maintain its tax-exempt status during a transitional period, which starts at the time of your death and ends at the earlier of:

- the end of the year following the year of your death; and
- the date the TFSA ceases to exist.

The portion of TFSA distributions that represent income earned on, or appreciation in the value of, the TFSA's property during the transitional period will be fully taxable to the recipient. During this transitional period, distributions received by the deceased's spouse or common-law partner can be contributed to the recipient's TFSA up to the fair market value of the property held by the deceased's TFSA at the time of death, without affecting the recipient's TFSA contribution room, if:

- the contributions are designated as "exempt contributions"; and
- a prescribed form is filed within 30 days of the contribution.

If the trustee TFSA still exists after the transitional period, the TFSA will become fully taxable and will be deemed to have disposed of, and reacquired its property for the property's fair market value at the end of the transitional period. Any transitional period income or appreciation that was not paid out during this period will be taxable to the TFSA, unless flowed out to the beneficiaries.

When the holder of a deposit or an annuity contract under a TFSA dies, the holder is considered to have received, immediately before death, the fair market value of the TFSA property at the time of death. All earnings that accrue after the holder's death will be taxable to the recipients.

TFSA and Marital Breakdown

Generally, upon marital breakdown, TFSA property can be transferred tax-free to the TFSA of a spouse or common-law partner or of a former spouse or common-law partner, without affecting the transferor's or transferee's TFSA contribution room.

TFSA and Non-Residents

If you become a non-resident of Canada, you can maintain your TFSA. You will not be taxed in Canada on any earnings in the TFSA or on withdrawals. Any withdrawals will be added to your unused TFSA contribution room in the following year, but will not be available until you resume Canadian residence.

As a non-resident, you cannot contribute to a TFSA and no contribution room will accrue for any year throughout which you are non-resident. If you contribute to a TFSA while you are non-resident, you will be subject to a tax of 1% per month on the contribution (exceptions apply) until the contribution is withdrawn or you resume Canadian residence (whichever is earlier). See the Appendix for details.

Depending on your country of residence, income earned in your TFSA may be taxable in that country in the year it is earned.

U.S. Citizens Resident in Canada

Depending upon their personal circumstances, U.S. citizens and U.S. green card holders who file U.S. resident tax returns may not benefit from a TFSA. It

appears that income earned in a TFSA will be taxable for U.S. purposes in the year it is earned.

Anti-Avoidance Rule

An anti-avoidance rule imposes a special tax (see the Appendix) if you or other non-arm's length persons have an "advantage" with respect to the TFSA. The tax is intended to prevent transactions that are designed:

- to artificially shift taxable income away from you into the shelter of a TFSA; or
- to circumvent the TFSA contribution limits.

Comparing Saving Options

Canadians have several vehicles to save money for retirement or other future use. Tables 3 and 4 (page 5) compare RRSPs, TFSA and ordinary investments. A brief discussion follows.

TFSA versus ordinary investments

You can simply invest funds, for example in GICs, the stock market or mutual funds. These investments give rise to annual investment income that is subject to income tax at your marginal tax rate. If you fund investments for the benefit of your spouse, the income earned on those investments generally will be taxable to you, eliminating the ability to have the income taxed at your spouse's lower tax rate.

Because investment income earned in a TFSA is not subject to income tax, your savings will increase more quickly within a TFSA than for investments held personally, assuming the same pre-tax rate of return. For example, if you contribute \$5,000 per year to a TFSA for 20 years, you will have approximately \$45,000 more in savings than if you contributed the same amount to a regular savings account, the income from which is taxed annually (assuming a rate of return of 5.5% per year, federal and provincial tax rate of 46% and the taxes are paid from the investment account.)

TFSA versus paying down mortgage on a principal residence

Another form of investment is to pay down the mortgage on your principal residence. Although you are not acquiring an asset that can produce investment income, reducing non-tax deductible interest is a valid investment option. As well, gains generated on your principal

residence are not subject to tax, making home ownership a tax-effective method of saving for Canadians.

Both mortgage repayments and contributions to a TFSA are made with after-tax dollars. Because income earned in a TFSA is not subject to tax, the comparison of the potential rate of return earned in a TFSA relative to the interest rate on the mortgage will be a key consideration when deciding between these alternatives.

Whether you use excess funds to pay down your mortgage or to make another investment depends on your specific situation. In particular, the relative merits of paying down your mortgage on a principal residence versus contributing to an RRSP have been long debated and the introduction of the TFSA complicates the issue.

Table 3 — Comparison of RRSP, TFSA and Ordinary Investments

	RRSP	TFSA	Ordinary investments
Contributions tax deductible?	Yes	No — see Table 4	No
Investment income taxed?	No		Yes — see Table 4
Withdrawals taxed?	Yes — see Table 4		No
Maximum contribution per year	Lesser of 18% of earned income and \$21,000 for 2009 (\$22,000 for 2010 and subsequently indexed for inflation)	\$5,000 for 2009 (subsequently indexed to inflation)	No maximum
Effect of withdrawals	<p>On contribution room</p> <p>Once funds have been withdrawn from an RRSP, the funds cannot be recontributed unless the plan holder has generated additional contribution room</p> <p>On income-tested benefits and credits</p> <p>Withdrawals increase taxable income and therefore may decrease income-tested benefits and credits, such as old age security and the age credit</p>	<p>Funds withdrawn from a TFSA may be recontributed to a TFSA. After a withdrawal, contribution room for the next year is increased by the amount of the withdrawal</p> <p>No effect</p>	N/A
Deemed disposition on death resulting in income tax	Yes — the full balance of the RRSP is subject to tax at taxpayer's marginal rates, unless the RRSP is transferred to spouse or, in certain circumstances, to a child	No — but, see Death of TFSA holder on page 3	Yes — accrued capital gains are subject to tax unless investments are transferred to the spouse
Transferable to spouse on death on a tax-deferred basis?	Yes		
Penalty on overcontributions	1% per month on excess contributions over \$2,000	1% per month on excess contributions	N/A

Table 4 — Tax Treatment of Investment Income

	RRSP ¹	TFSA	Ordinary investments ¹
Interest	Fully taxable at withdrawal	Tax-free	Fully taxable; taxable at up to 48%
Capital gains			50% tax-free; taxable at up to 24%
Capital losses	In effect, fully deductible	Not tax deductible	50% is tax deductible against capital gains
Canadian dividends	Fully taxable at withdrawal, but dividend tax credits are lost ²	Tax-free, but dividend tax credits are lost ²	Taxable at up to 30%
			Taxable at up to 38%

1. Tax rate depends on income level and jurisdiction of residence.

2. Tax credits are higher for eligible dividends.

TFSA versus contributing to an RRSP

If you contribute to an RRSP you will be entitled to deduct the contribution from income, reducing your tax payable for the year as well as the effective cost of the contribution (i.e., amount contributed less the tax savings). Investment income accumulates tax-free within the RRSP, but RRSP withdrawals are subject to tax at your marginal tax rate. You can make tax deductible contributions to a spousal RRSP, which allows for income splitting with your spouse when the funds are eventually withdrawn from the RRSP. However, the new pension-splitting rules have reduced the significance of the spousal RRSP.

Both a TFSA and an RRSP allow your investment to grow tax-free as long as the funds remain in the plan. With an RRSP, the contributions are tax-deductible, reducing the upfront cost of the investment. Investment income earned in an RRSP loses its character, so that when the income is withdrawn from the RRSP, the income is taxed as ordinary income, rather than at the preferential tax rates for capital gains or dividends. Contributions to a TFSA are not deductible for income tax purposes; however, the original TFSA contributions and the related investment income are not taxed, even when the funds are withdrawn.

In addition, when you withdraw funds from an RRSP, the contribution room is lost, and the funds cannot be recontributed to an RRSP unless you generate additional RRSP contribution room. Funds withdrawn from your TFSA can be recontributed at any time after the end of the year, while you are resident in Canada.

TFSAs can also be a good supplement to RRSPs. You can continue to contribute to TFSAs after the age of 71, when RRSPs must be collapsed and any payments from a TFSA will not affect your eligibility for federal

government assistance programs such as Old Age Security.

Further, you should compare your RRSP and TFSA contribution limits. For example, an individual with earned income (i.e., from employment) of \$25,000 a year who is not a member of a company pension plan, will have a RRSP contribution limit of \$4,500 ($\$25,000 \times 18\%$), which is less than the TFSA contribution limit.

Given the differences in the tax treatment of RRSPs and TFSAs, the decision of whether to invest in an RRSP or TFSA must be made case by case. There is no one-size-fits-all solution.

TFSA versus direct corporate share ownership

A significant planning opportunity may exist if you and persons not dealing at arm's length with you, together own less than 10% of a "specified small business corporation." Generally, a "specified small business corporation" is a Canadian-controlled corporation in which substantially all of the fair market value of the corporation's assets is attributable to assets that are:

- used principally in an active business carried on primarily in Canada; or
- shares or debt of specified small business corporations that are connected to the corporation.

If these criteria are met, you can hold your shares in the corporation in your TFSA. This would exempt the dividends and capital gains from income tax when earned by the TFSA and when withdrawn by you. The rules are complex. Consult your PricewaterhouseCoopers adviser or any of the individuals on page 8 to determine if you can take advantage of this planning opportunity.

Appendix — TFSA Penalty Taxes¹

	What is the penalty tax?	Explanations	Can the Minister waive the penalty tax?
Overcontributions	1% per month on excess contributions	This tax is similar to the penalty tax on excess RRSP contributions. However, while a \$2,000 margin for error is permitted for RRSP overcontributions, every dollar of TFSA overcontributions will be penalized.	Yes ³
Non-resident contributions	1% per month on contributions made by non-residents ²	You will be subject to the 1% per month tax until the contributions are withdrawn or you resume Canadian residence (whichever is earlier).	
“Non-qualifying”⁴ and/or “prohibited” investments	50% of the fair market value of the “prohibited” or “non-qualifying” property	This is a one-time tax that becomes payable when the TFSA acquires the prohibited or non-qualifying property or the property becomes prohibited or non-qualifying. The tax can be refunded if the TFSA disposes of the non-qualifying or prohibited property before the end of the calendar year following the calendar year in which the tax arose. However, no refund is available if it is reasonable to expect that you knew or should have known that the property was, or would become non-qualified or prohibited.	
“Prohibited” investments	Additional tax on income derived from prohibited investments	The income that is subject to the penalty tax includes: <ul style="list-style-type: none"> the actual amount of dividends received (the dividend tax credit rules do not apply); capital dividends (these are fully taxable); and the full amount of capital gains, net of capital losses (the 50% inclusion rate does not apply). The income is taxed at a rate of 43.5% (i.e., the top federal personal income tax rate (29%) X 150%). The additional 50% ensures that there is no provincial income tax advantage to holding a prohibited investment in a TFSA.	No
TFSA holder has an “advantage”	The tax is based on the value of the “advantage”	An “advantage” is any benefit, loan or indebtedness that depends on the existence of the TFSA. Exceptions include: <ul style="list-style-type: none"> TFSA withdrawals; administrative or investment services in connection with the TFSA; loans and debt that are on arm’s-length terms; and payments or allocations to the TFSA by the issuer (e.g., reasonable payments of bonus interest). The amount of tax is equal to the fair market value of the benefit and/or the amount of the loan or indebtedness. In certain cases, an “advantage” also includes any increase in the fair market value of property held in a TFSA. This tax is intended to prevent transactions that are designed to artificially shift taxable income away from the TFSA holder and into the shelter of a TFSA or to circumvent the TFSA contribution limits.	Yes ³

- Penalty taxes are imposed on the TFSA holder, except for certain cases involving a TFSA “advantage,” when the TFSA issuer may be liable. You must file a return and remit the penalty taxes (net of an allowable refund) within 90 days after the end of the year (March 31; March 30 for leap years).
- Exceptions apply for transfers from another TFSA of the TFSA holder and for certain contributions on a marriage breakdown or on the TFSA holder’s death.
-

When the Minister may waive the tax	
Overcontributions	If the contributions arose because of a reasonable error and you withdraw them without delay.
Non-resident contributions	
“Non-qualifying” and/or “prohibited” investments	If it is just and equitable to waive the tax having regard to all the circumstances, including whether the tax arose as a consequence of reasonable error, and the extent to which the transaction that gave rise to the tax also gave rise to another tax.
TFSA has an “advantage”	

- The TFSA may also be taxable on any investment income earned from non-qualifying investments, as explained under **TFSA income subject to tax** on page 3. However, for the purpose of applying this tax, if the investment is both “non-qualifying” and “prohibited,” it will be deemed to be a prohibited investment only, and an additional penalty tax (discussed above) will apply to the TFSA holder.

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1. Member of PricewaterhouseCoopers' Canadian National Technical Services (CNTS). CNTS comprises a multi-disciplinary group of tax accountants, lawyers and other specialists from a variety of professional backgrounds in taxation, including government, with the mandate to enhance the overall value and scope of tax services PricewaterhouseCoopers provides to its clients.

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