



JANUARY 18, 2010

KNV TAX MEMO

TAX-FREE SAVINGS ACCOUNTS (TFSAs)

WHO CAN OPEN A TFSA?

Canadian residents aged 18 or older having a valid social insurance number can open a TFSA.

HOW MUCH CAN YOU CONTRIBUTE?

You can contribute up to \$5,000 to a TFSA each year. The \$5,000 annual contribution limit will be indexed to inflation in \$500 increments, starting in 2010.

Contributions to your TFSA cannot exceed your contribution room (including carryovers) for the year. TFSA over-contributions are subject to a 1% penalty tax per month in the same way as RRSP over-contributions. However, in the case of the TFSA, there is no \$2,000 margin for error which is available for RRSP over-contributions. The Canada Revenue Agency (CRA) will advise you of your contribution limit on your Notice of Assessment. Therefore, you will have to track your TFSA limit and compare it to the contributions made

Any unused contribution room in a particular year is automatically carried forward and added to your contribution room for future years.

WHY CONTRIBUTE TO A TFSA?

There are a number of advantages to contributing to a TFSA:

1. *Tax-free earnings* – Income earned in a TFSA is not taxable, which allows you to grow funds faster than if invested outside of a TFSA.
2. *Contribution room is not lost on withdrawal* – You can make a tax-free withdrawal from a TFSA at any time. When you make such a withdrawal, the amount withdrawn will be added to your contribution room in the next year and can be re-contributed in the future.
3. *Income splitting* – The income attribution rules do not apply to TFSAs. Therefore, you can gift or loan funds to your spouse and/or other adult family members (i.e. 18 or older) in order for them to make a TFSA contribution. The income earned in their TFSAs will not be taxable to you.
4. *Income-tested benefits* – Neither earnings in a TFSA nor withdrawals will affect income-tested federal benefits such as Old Age Security, GST/HST tax credits, Canada Child Tax Benefits and Employment Insurance Benefits.
5. *TFSAs for seniors* – Unlike an RRSP, which has to be wound up by the end of the year in which you reach age 71, you can still contribute to a TFSA after you turn 71. In addition, income derived from a TFSA has no impact on seniors' eligibility for Guaranteed Income Support and Old Age Security.

WHERE TO ACQUIRE A TFSA?

The same financial institutions that are currently permitted to administer RRSPs are able to administer TFSAs. Such financial institutions include Canadian trust companies, investment brokerage companies, life insurance companies, banks and credit unions.

WHICH INVESTMENTS QUALIFY?

TFSAs are generally allowed to hold the same qualified investments as RRSPs such as cash, guaranteed investment certificates (GICs), term deposits, mutual funds, government and corporate bonds, publicly traded securities, and in certain cases, shares of small business corporations.

Your TFSA cannot hold investments in “non-arm’s length entities”, which generally means companies in which you, your spouse, and other related persons, either individually or collectively, own 10 percent or more of the shares. Furthermore, recent CRA pronouncements suggest that they will scrutinize any arrangement that involves a TFSA investment in a small business corporation where the investment by the TFSA would not have been available in the absence of a special relationship between the TFSA holder and the small business corporation. Note that violations of the TFSA rules can trigger significant penalties, so professional advice should be sought before initiating a TFSA investment in a small business corporation.

RRSPS AND TFSAs

A TFSA is like a mirror image of an RRSP. RRSP contributions are tax-deductible, but any withdrawals are fully taxable. TFSA contributions are not tax-deductible, but withdrawals are tax-free.

As a result, your best tax strategy for dividing your investments between TFSAs and RRSPs may depend on the difference between your current tax bracket and the one you expect to be in when you start withdrawing funds from your RRSP. If you expect your tax rate to increase in future, a TFSA may be preferred because the higher future tax rate will be avoided. If you expect your tax rate to decline, an RRSP may be the better choice.

SPECIAL SITUATIONS

Various rules apply to special situations, including the death of a TFSA holder and ceasing Canadian residency.

1. *Death* – On the death of a TFSA holder, amounts that have accrued in the account remain tax-exempt. Generally, investment income earned in the TFSA after the account holder’s death is no longer tax-exempt unless the assets in the account are transferred to a surviving spouse’s TFSA within two years. This transfer will not affect the surviving spouse’s contribution room.
2. *Marital breakdown* – Generally, upon marital breakdown, TFSA assets 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.
3. *Non-residents* – if you become non-resident, you can maintain your existing TFSA and your investment income, and withdrawals will remain exempt from Canadian tax. However, while you are non-resident, no new contribution room will accrue. You also need to consider the foreign tax implications of TFSA income and withdrawals.

4. *U.S. citizens living in Canada* – U.S. citizens and other “U.S. persons” such as green card holders are subject to U.S. tax on their worldwide income. Under the current Canada-U.S. Tax Treaty, U.S. persons in Canada can elect to defer income earned in certain plans such as RRSPs or RRIFs for U.S. tax purposes until it is withdrawn. However, since TFSA contributions and withdrawals are not linked to employment or retirement, TFSA earnings will be treated as an ordinary investment account for a U.S. person and will be part of a U.S. person’s taxable income for U.S. tax purposes. However, it may still be beneficial for a U.S. person to establish a TFSA if he or she has sufficient foreign tax credits to absorb the additional income reported for U.S. tax purposes.

KNV CAN HELP

If you have any questions on the TFSA rules, please contact your KNV advisor.

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