Tax Free Savings Account (TFSA)

For people who have used up all their RRSP contribution room, for young people starting out or those who are too old to contribute to an RRSP, there are no good reasons for not opening a TFSA.

- Unlike income earned in an unregistered account, income earned in a TFSA is non-taxable, producing tax savings equivalent to the taxpayer's marginal rate.
- For higher income seniors who are subject to claw back of the Old Age Security or age amount, the tax savings will be even more substantial.
- For lower income seniors, amounts earned in a TFSA are excluded from the calculation of benefits such as the GST/HST Credit and the Guaranteed Income Supplement.
- For young people just starting out, in a low tax bracket now, expecting to increase earnings and be in a higher tax bracket in a few years. At that time, the TFSAs could be transferred to an RRSP, making the contribution when the tax savings is greater. Make the transfer near the end of a calendar year, so that the withdrawal increases your TFSA contribution room sooner.

However for taxpayers who are still able to contribute to an RRSP, the issues arise as to whether they should contribute to a TFSA when they still have RRSP deduction room available. The question also arises as to what type of investment should be kept in a TFSA.

What Type of Investment to Hold in a TFSA?

The decision as to what type of investment should best be kept in a TFSA probably depends on what it is being used for. Taxpayers who are using their TFSA to save for a car or new furniture will probably make different investment choices than those who want to use it to supplement their retirement savings. Here are some factors to take into consideration:

- Unlike dividends and capital gains which receive preferential tax treatment, interest income held in non-registered plans is taxed at the taxpayer's marginal rate. Taxpayers who want to set aside some money for short term use in interest bearing investments may want to use their TFSA for this purpose
- Because distributions from a TFSA are not included in income, the profits in a TFSA from investments held in a TFSA are essentially non-taxable. Some commentators therefore advise that TFSAs should be reserved for investments that yield capital growth, especially if the choice is between a TFSA and an RRSP (in which capital appreciation is fully taxable at the time of withdrawal).
- Taxpayers who are risk-averse should be aware that if capital investments in a TFSA shrink instead of grow, the resulting capital loss cannot be used to offset capital gains realized from non-registered investments. In the event that the investment is withdrawn from the TFSA, the reduction in value will also be reflected in reduced TFSA contribution room
- Dividends from U.S. corporations are exempt from U.S. tax withholding when received by an RRSP under Article XXI (2) of the Canada – United States tax treaty. They will not be exempt from U.S. tax withholding when received by a TFSA. If there is a choice between holding shares of U.S. corporations in an RRSP or a TFSA, they should therefore be kept in an RRSP

Summary Review

- RRSP is pre-tax dollars invested and are taxed when you withdraw.
- TFSA is after tax dollars invested and no tax when you withdraw.

TFSA is Best for:

- low income earners, especially those under $40,000, and who stay there throughout their life
- rising income, e.g. those early in their career whose incomes will rise with time or; those who expect a large inheritance that will boost their investment income; the general idea is those for whom the tax rate on withdrawal will be higher than when they contribute are best off in a TFSA
- very high income earners of $110,000+ (but with either very low retirement savings (under $250k, including pension value, at point of retirement), or with a substantial pension savings amount i.e. over $750k in total value
- prone to spend RRSP tax refund - to get max RRSP effect you must reinvest the refund
- plan to use TFSA as an emergency fund - TFSA withdrawals can be replaced later, i.e. the contribution room is not lost, as is the case with RRSPs
- spouse with low or no income - TFSA enables immediate investment income splitting with spouse, since contribution to spousal TFSA never triggers income attribution back to contributor, but an RRSP has significant such restrictions; a no-income spouse would not earn RRSP contribution room to use anyway.
- retired but with excess income - i.e. a place to park funds for tax-free growth; this is unlike RRSPs, which must be converted to RRIFs or annuities by age 71 and which means withdrawals / paying tax on income, with no contributions allowed

RRSP is Best for:

- lower income and/or tax rate on withdrawal; withdrawals are usually lower during retirement, but not always
- income earners in the $40,000 to $50,000 range and $75,000 to about $90,000 – unless they have other deductions
- high income earners, the higher the income, the greater the advantage - true partly because of the higher tax rate being avoided through the contribution along with the tax-free compounding of the amount deferred and partly due to the higher contribution limit on RRSPs, which allows you to save more
- investment income splitting with spouse during retirement - after maxing out splitting using TFSAs
- helping stick with regular saving and not withdrawing un-necessarily or prematurely - the idea of losing RRSP contribution room, or paying taxes on withdrawals before retirement may help avoid dipping into it for discretionary spending; conversely the attraction of the tax refund can help motivate the contribution and the saving that represents.

Thoughts

Despite any financial decision you make with your investments, make sure you review your goals every year as life is full of surprises. What works today may not be the best decision as a result of changes in your life tomorrow.

Remember it is your money and your age and proximity to retirement has a lot to do with your investment choices, or it should. You need to make the most out of it - have a plan to maintain your life style or the one you would like to have when you retire.