

Tax Free Savings Accounts

Cutting Through The Confusion

Recently there have been a number of news stories, both on television and in the newspapers, which have relayed situations where Canadians have run into "tax trouble" with Canada Revenue Agency as a result of improper transactions through their Tax Free Savings Account (TFSA). For this reason, I decided to revisit the TFSA in order to clarify how it works and how it can benefit you now and in retirement.

First a bit of background. In 2009, the TFSA was introduced by the Federal Government, arguably the single most important personal savings vehicle since the introduction of the Registered Retirement Savings Plan (RRSP). The TFSA allows Canadians to invest in a wide range of investments without having to worry about the tax implications resulting from appreciation of the investment while inside the TFSA or the tax implications resulting at the time of withdrawal.

As good as this investment vehicle is, there are several things that the Canadian investor must know in order to ensure they get the full benefits associated with this product. First, here's a list of the facts...

- If you are a Canadian resident aged 18 or older, you can save up to \$5,000 every year in a TSFA.
- Your contributions to a TFSA are not deductible for income tax purposes but the investment income, including capital gains, earned in your TFSA is not taxed, even when withdrawn.
- Your unused TFSA contribution room is carried forward and accumulates for future years.
- Neither income earned in a TFSA nor withdrawals affect your eligibility for federal income-tested benefits and credits.
- You can provide funds to your spouse or common-law partner to invest in their TFSA.
- TFSA assets can generally be transferred to a spouse or common-law partner upon death.

So how does it work and why should Canadians embrace the Tax Free Savings Account? The TFSA has many applications. Unlike the RRSP that is intended for retirement, the TFSA not only has significant benefits in retirement but has many uses in many stages of life.

Whether you are savings for a home, vehicle or a family vacation, the TFSA will allow you to invest up to \$5,000 per calendar year without having to worry about being taxed on the money your investment earns. If you have children or grandchildren and have already contributed the maximum to their Registered Education Savings Plan for university or college, consider a TFSA to help pay for additional expenses they may incur during their post-secondary education. In retirement, you can keep your RRSP tax-sheltered until age 71 while you supplement your retirement income tax-free with your TFSA.

So where is the confusion? It lies in the timing of when you are allowed to actually contribute to a TFSA and the rules surrounding the withdrawal from a TFSA. First, provided you are aged 18 or older and a Canadian resident, you can contribute up to \$5,000 annually to your TFSA. If you only contribute \$3,000 in 2010, you will be able to contribute as much as \$7,000 in 2011.

When you make a withdrawal from your TFSA, you can redeposit those funds into the plan in a future calendar year. For example, if you deposit \$5,000 into your TFSA in 2010 and decide to withdraw \$2,000 later in 2010, you must wait until at least 2011 before putting those funds back in. Your contribution room for 2011 would increase by that \$2,000 withdrawal, allowing you to contribute \$7,000 in 2011. However, if you fail to wait until the next calendar year before you replace your withdrawal, Canada Revenue Agency will consider the replacement of funds as an over-contribution into the plan and you will be assessed a tax penalty. If you are at all concerned about the tax implications, it's best to consult a qualified financial advisor.

To discuss this article or to arrange a free, no obligation review of your portfolio, please contact me at larry.gallant@queensbury.com or by calling 905-892-2100.

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