



Federal Budget 2008

A Warm Welcome to the TFSA

Finance Minister Jim Flaherty introduced a number of tax-related measures in his Budget this week, the most significant of which is a new savings plan that will be of great benefit to our clients, the **Tax-Free Savings Account (TFSA)**.

Tax-Free Savings Account (TFSA)

Effective in 2009, Canadians 18 years of age and over will be able to accumulate money on a **tax-sheltered** basis in a TFSA and ultimately withdraw the proceeds **tax-free** for **any** purpose over their lifetimes. While contributions are not tax-deductible, you will acquire \$5,000 of TFSA contribution room each year. In addition, the \$5,000 will be indexed to inflation.

Equally important, unused contribution room can be carried forward indefinitely to future years, without limitation. For example, if you contribute \$2,000 to a TFSA in 2009, your contribution room for 2010 will be \$8,000 (\$5,000 for 2010 plus \$3,000 carried forward from 2009). One interesting twist is that you can “recontribute” amounts taken out of the plan. In other words, any amount that you withdraw in a particular year will be added to your contribution room for the following year.

The ability to accumulate investment capital in the TFSA on a tax-free basis, and pay no taxes when you withdraw all or a portion of the proceeds, will allow you to use the TFSA for many purposes. Beyond the obvious use of building a pool of retirement capital, particularly for those who have maxed out their RRSPs, we envision these plans being used to accumulate a down payment for the purchase of a home, to save for an automobile, to set aside money for a wedding – you name it. A TFSA would also be an excellent vehicle for capital that you want to keep liquid for emergencies.

While qualified investments will be the same as for an RRSP, we can see the TFSA being an excellent vehicle for fixed income investments (GICs, bonds, money market) to eliminate the heavy tax burden of interest income as much as possible. Or alternatively, to hold investments generating foreign dividends which do not receive the benefit of the dividend tax credit and hence are taxed at a much higher rate.

Furthermore, the income generated within the TFSA will have no impact on our income-tested benefits such as the Canada Child Tax Benefit, the Goods and Services Tax Credit, and the Age Credit, nor will it impact the clawback of Old Age Security benefits. And, if you give money to your spouse or common-law partner to take advantage of TFSA contribution room, there is no “attribution” of the income earned, as is the case when you transfer property to a spouse or common law partner.

Here are some other TFSA details worth noting:

- A TFSA plan can be transferred tax-free on death to a spouse or common-law partner as the

“successor account holder”. Or, the assets of the plan itself can be transferred regardless of whether the survivor has available contribution room, and without reducing the survivor’s contribution room.

- In the event of a marriage or common-law partnership breakdown, an amount may be transferred from one spouse’s TFSA to the other’s, but this will *not* reinstate contribution room of the transferor, nor will it impact the available contribution room of the transferee spouse.
- The Canada Revenue Agency will track TFSA contribution room when you file your annual income tax return, just as they currently do for RRSP contribution room.
- You can have more than one TFSA.

As you read this, the question that probably comes to mind is, how does a TFSA compare to both an RRSP and unregistered savings. The chart and commentary below is from the Budget documents. It assumes

Tax Treatment and After-Tax Returns: TFSAs, RRSPs and Unregistered Savings

The tax assistance provided by a TFSA is, in many ways, a mirror image of that provided through RRSPs.

- RRSP contributions are tax deductible, with both the contributions and the investment earnings taxable upon withdrawal.
- TFSA contributions are made from after-tax income, with both the contributions and the investment earnings exempt from tax upon withdrawal.

The following table shows that the net after-tax rates of return on TFSA and RRSP savings are equivalent when effective tax rates are the same at the time of contribution and withdrawal: the value of the tax deduction available for RRSP contributions is equivalent to the value of withdrawing funds from a TFSA on a tax-free basis. The rate of return from saving in either a TFSA or an RRSP is superior to unregistered saving. The following table shows the after tax return of a TFSA, an RRSP and unregistered savings.

Net Proceeds from Saving in a TFSA Relative to Other Savings Vehicles

	TFSA	RRSP	Unregistered Savings
Pre-tax income	1,000	1,000	1,000
Tax (40% rate)	400	-	400
Net contribution ¹	600	1,000	600
Investment income (20 years at 5.5%)	1,151	1,918	707 ²
Gross proceeds			
(Net contribution + investment income)	1,751	2,918	1,307
Tax (40% rate)	-	1,167	-
Net proceeds	1,751	1,751	1,307
Net annual after-tax rate of return ³ (%)	5.5	5.5	4.0

¹ Forgone consumption (saving) is \$600 in all cases. In the RRSP case, the person contributes \$1,000 but receives a \$400 reduction in tax, thereby sacrificing net consumption of \$600.

² For unregistered saving case, tax rate on investment income is 28%, representing a weighted average tax rate on an investment portfolio comprised of 30% dividends, 30% capital gains and 40% interest.

³ Measured in relation to forgone consumption of \$600. Assumes annual nominal pre-tax rate of return is 5.5% invested for 20 years.

A TFSA will provide a net rate of return equal to the pre-tax rate of return (5.5% in the example). RRSP saving will provide a net rate of return higher than the TFSA when the effective tax rate on the withdrawal is lower than the effective tax rate on the contribution, and a net rate of return lower than the TFSA when the effective tax rate on the withdrawal is higher than at the time of contribution.

\$1,000 is available for investment and details the effect of contributing to a TFSA, RRSP, or a traditional unregistered savings account.

What is interesting about this comparison is that it assumes that your effective tax rate will be the same at the time you contribute and on withdrawal. In any individual situation it will be important to look at all future potential sources of income, say on retirement, e.g. pensions, non-TFSA investments, and the effective tax rates that result, in order to further analyze the pros and cons of TFSAs and RRSPs.

For example, if an analysis determines that you will have a lower effective tax rate in retirement, then the RRSP is the preferred, first choice saving vehicle. Alternatively, if you will have a higher effective tax rate in retirement, then the TFSA is a good vehicle for you. On the surface, however, it seems to us that the TFSA will be an extremely useful vehicle for *most* Canadians.

We look forward to offering the Tax-Free Savings Accounts to our clients in 2009.

Other Tax Measures

Here is a brief summary of other tax measures introduced in the Budget:

- Increased flexibility for federal Life Income Funds (LIFs) – those of you have LIFs from pension plans subject to federal legislation, e.g. Banks, federal government employees, now have greater access to your money beyond the current annual maximum income allowed. A one-time transfer of up to 50% to a RRIF or New LIF will be allowed, as will withdrawals for reasons of financial hardship or of small balances.
- An increase in the period over which RESP benefits may be accumulated or withdrawn, from 21 years and to age 25 respectively, to 31 years and to age 35.
- An adjustment to the “gross up” of dividends and the dividend tax credit to reflect the drop in corporate tax rates.
- The extension of the exemption from capital gains tax on the donation of listed securities to private charitable foundations. (Previously this tax exemption applied to donations of such securities to registered charities and public foundations).
- Amendment of the new Registered Disability Savings Plan (RDSP) introduced in the 2007 Budget as a tax-assisted savings vehicle for the support of severely disabled children. Currently the objective is still to have the regulations and administrative rules in place so that these plans can be offered this year for the first time.

We welcome your questions or comments on any of the above measures.

As always, there are enough things in life to worry about. Money doesn't have to be one of them. Let us show you how.

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