

Tax Free Savings Accounts

The Government of Canada passed a new law creating the Tax Free Savings Account (TFSA) which became effective January 1st 2009. Any Canadian over the age of 18 can now invest \$5,000 per year into an investment account that will grow tax free. You will never pay tax on the growth of any money invested in a TFSA.

From our point of view at Singer Olfert Financial Group the Tax Free Savings Account (TFSA) is very exciting and provides an amazing opportunity.

How can a Tax Free Savings Account Help?

Below in the chart is an example showing the difference between holding individual GIC's (in a traditional investment account) versus holding a money Market Mutual fund within the TFSA. A money market fund is a diversified mutual fund portfolio made up of many GIC's and T-bills.

This table illustrates how a money market fund purchased within a TFSA compares to buying a GIC in protecting capital and generating growth on an after-tax basis.

Year	Money market fund in a TFSA				GIC in a non-registered account			
	Annual Deposit	Annual Growth	Tax paid on Growth	After-tax Balanced	Annual Deposit	Annual Growth	Tax paid on Growth	After-tax Balanced
1	\$5,000	\$150	\$0	\$5,150	\$5,000	\$150	\$68	\$5,083
2	\$5,000	\$305	\$0	\$10,455	\$5,000	\$302	\$136	\$10,249
3	\$5,000	\$464	\$0	\$15,918	\$5,000	\$457	\$206	\$15,500
4	\$5,000	\$628	\$0	\$21,546	\$5,000	\$615	\$277	\$20,839
5	\$5,000	\$796	\$0	\$27,342	\$5,000	\$775	\$349	\$26,265
6	\$5,000	\$970	\$0	\$33,312	\$5,000	\$938	\$422	\$31,781
7	\$5,000	\$1,149	\$0	\$39,462	\$5,000	\$1,103	\$497	\$37,388
8	\$5,000	\$1,334	\$0	\$45,796	\$5,000	\$1,272	\$572	\$43,087
9	\$5,000	\$1,524	\$0	\$52,319	\$5,000	\$1,443	\$649	\$48,881
10	\$5,000	\$1,720	\$0	\$59,039	\$5,000	\$1,616	\$727	\$54,770
11	\$5,000	\$1,921	\$0	\$65,960	\$5,000	\$1,793	\$807	\$60,756
12	\$5,000	\$2,129	\$0	\$73,089	\$5,000	\$1,973	\$888	\$66,841
13	\$5,000	\$2,343	\$0	\$80,432	\$5,000	\$2,155	\$970	\$73,026
14	\$5,000	\$2,563	\$0	\$87,995	\$5,000	\$2,341	\$1,053	\$79,314
15	\$5,000	\$2,790	\$0	\$95,784	\$5,000	\$2,529	\$1,138	\$85,705
Total	\$75,000	\$20,784	\$0	\$95,784	\$75,000	\$19,463	\$8,759	\$85,705

Assumptions
 Initial Investment \$5,000
 Subsequent Purchases \$5,000
 Interest Rate / Growth Rate 3%
 Investor's Marginal Tax Rate 45%
 Income Taxed as Ordinary Income (100% of MTR)
 Investment Period 15 years

Based on the assumptions outlined above, investing \$5,000 each year in a Tax-Free Savings Account instead of a regular non-registered investment account would result in an additional \$10,080 in combined tax savings and compounded growth.

After-tax growth of the money market fund in a TFSA – **\$20,784** After-tax growth of the GIC in a non-registered account – \$10,704.

Between the tax on the growth and missing opportunity of compounding, the non-registered account balance is \$10,080 or 48.5% less than what could have been earned in a TFSA.

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The tax free advantage is obvious, so how does it work?

How the TFSA Works?

Investing:

- Unlike RRSP's contributions to a TFSA are not deductible for income tax purposes at the time of investing.

- Similar to an RRSP unused TFSA contribution room can be carried forward to future years
- Contribution limits are cumulative (\$5000 added each year to an individual's previous limit)
- Eligible investments include Mutual Funds

Growth:

- Investment income, including capital gains, earned in a TFSA will not be taxed, even when withdrawn
- Returns can be compounded tax free

Withdrawal:

- You can withdraw funds from the TFSA at any time for any purpose
 - The amount withdrawn can be put back in the TFSA at a later date without reducing your contribution room
- One of the most interesting parts of the TFSA is that withdrawals are allowed at any time, for any purpose, tax free. The withdrawal will create new contribution room for the following year – in addition to the \$5000 granted each year. Unlike RRSP withdrawals that result in the permanent loss of contribution room, TFSA withdrawals will restore contribution by the amount of the withdrawal.

Interesting Facts:

- Contributions to a spouse's TFSA will be allowed and TFSA assets can be transferred to a spouse upon death
- TFSA's can be used as collateral for a loan
- Interest on money borrowed for TFSA use will not be tax-deductible
- Neither income earned in a TFSA nor withdrawals will affect your eligibility for federal income tested benefits and credits

How Is a TFSA Different From a Registered Retirement Savings Plan (RRSP)?

RRSP is primarily intended for retirement. *The TFSA is like an RRSP for everything else in your life.* Both plans offer tax advantages, but they have key differences:

- Contributions to an RRSP are deductible and reduce your income for tax purposes. In contrast, your initial TFSA deposits will not be deductible.
- Withdrawals from an RRSP are taxed just like regular income. Any money taken out of your TFSA will be tax-free.

Comparison of Benefits Between an RRSP and a TFSA

	RRSP	TFSA
Investments are tax deductible	YES	NO
Funds grow and compound in a tax free environment	YES	YES
Funds can be used as collateral for a loan	NO	YES
Funds are withdrawn tax free	NO	YES
Wide variety of eligible investments including Mutual Funds	YES	YES

Which is better an RRSP account or a TFSA?

The answer is it depends. Let's take a look at a comparison of the 2 options.

	TFSA	RRSP
Incom	\$ 1,000	\$ 1,000
Tax (at 40%)	(400)	–
Amount	600	1,000
Growth – 10 years /	1,015	1,692
Tax (at 40%)	–	(677)
Net available to spend	\$ 1,015	\$ 1,015

So if you are expecting your tax rate to be the same when you need the money then either option will work.

If you expect your tax rate to be lower – than the RRSP could be the better choice. The reverse could be true if you expect your income to be higher.

Using TFSA to Accelerate your Retirement Plan

For investors looking to stretch their RRSP contributions further, a strategy that involves rolling the RRSP tax refund into a Tax-Free Savings Account can add considerable assets to one's retirement fund. On top of the additional assets, having a TFSA allows the investor to reduce their tax rate in retirement by ensuring that not all of their income is coming out of a RRIF. Remember that income from a RRIF is considered taxable income. Money withdrawn from a TFSA is not taxed as income. Plus, the assets in a TFSA are able to compound and grow faster since they're not taxed.

Here is a chart showing an individual contributing \$10,000 per year into their RRSP account and then using their \$4000 refund from their tax return to invest in a mutual fund portfolio with a TFSA. The end result is quite staggering. At the start of the 16th year of investing the individual will have an extra \$104,473 of tax free money at their disposal which is the equivalent of having \$175,000 if held within an RRSP (assuming an average return of 7.5% and a marginal tax rate of 40%). This can be a great strategy to pay yourself first for retirement planning.

This table illustrates how using the tax refund received on an RRSP contribution can be reinvested into a TFSA to generate even more tax free growth and provide a larger asset base at retirement.

Year	RRSP Account				TFSA Account		
	Annual RRSP Contribution	Annual Growth	Balance	Tax Refund	Previous year's Tax Refund to TFSA*	Annual Growth	Balance
1	\$10,000	\$750	\$10,750	\$4,000	\$0	\$0	\$0
2	\$10,000	\$1,556	\$22,306	\$4,000	\$4,000	\$300	\$4,300
3	\$10,000	\$2,423	\$34,729	\$4,000	\$4,000	\$623	\$8,923
4	\$10,000	\$3,355	\$48,084	\$4,000	\$4,000	\$969	\$13,892
5	\$10,000	\$4,356	\$62,440	\$4,000	\$4,000	\$1,342	\$19,234
6	\$10,000	\$5,433	\$77,873	\$4,000	\$4,000	\$1,743	\$24,976
7	\$10,000	\$6,590	\$94,464	\$4,000	\$4,000	\$2,173	\$31,149
8	\$10,000	\$7,835	\$112,298	\$4,000	\$4,000	\$2,636	\$37,785
9	\$10,000	\$9,172	\$131,471	\$4,000	\$4,000	\$3,134	\$44,919
10	\$10,000	\$10,610	\$152,081	\$4,000	\$4,000	\$3,669	\$52,588
11	\$10,000	\$12,156	\$174,237	\$4,000	\$4,000	\$4,244	\$60,832
12	\$10,000	\$13,818	\$198,055	\$4,000	\$4,000	\$4,862	\$69,695
13	\$10,000	\$15,604	\$223,659	\$4,000	\$4,000	\$5,527	\$79,222
14	\$10,000	\$17,524	\$251,184	\$4,000	\$4,000	\$6,242	\$89,464
15	\$10,000	\$19,589	\$280,772	\$4,000	\$4,000	\$7,010	\$100,473
16*					\$4,000	\$0	\$104,473
Total	\$150,000	\$130,772	\$280,772		\$60,000	\$44,473	\$104,473

Assumptions

- Annual RRSP Deposit: \$10,000
- Growth Rate (on RRSP): 7.5%
- Growth Rate (on TFSA): 7.5%
- Investor's Marginal Tax Rate: 40%
- Years to Retirement (Investment Period): 15 years

*This illustration assumes that the tax refund realized on the RRSP Contribution is invested in a TFSA at the start of the following year. In the final year of the illustration, that year's RRSP refund is applied to the end balance of the TFSA with no further growth calculated.

<p>Annual RRSP contributions of \$10,000 at 7.5% annual rate of return = Retirement Savings of \$280,772.</p>	<p>Annual RRSP contributions of \$10,000, with reinvested tax refund into TFSA at 7.5% annual rate of return = Combined Retirement Savings of \$385,246.</p>
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Who is an ideal TFSA Candidate?

All income earners can benefit from the TFSA. Whether it means saving for a dream vacation, a down payment for a home, children's education or retirement, the tax exempt status on investment income and withdrawals will help achieve any financial goal much sooner.

1. Seniors will be able to save and still collect Old Age Security. Individuals just starting a career can use the TFSA and build RRSP contribution room to use in later years when they earn more.
2. Young couples can save for the education of their children; affluent individuals can set aside funds as part of their estate plans. There are numerous variations, so you could sum up the ideal candidate: Canadians 18 years and older.

No Impact on Income-Tested Benefits:

Neither income earned in a TFSA nor withdrawals will affect your eligibility for federal income-tested benefits and credits, such as the Guaranteed Income Supplement and the Canada Child Tax Benefit. This will improve incentives for people with low and modest incomes to save.

It is estimated that, in the first five years, over 75 per cent of the benefits of TFSA savings will go to individuals in the two lowest income tax brackets.

Benefits for Low- and Modest-Income Canadians:

Alexandre and Patricia, a modest-income couple, expect to receive the Guaranteed Income Supplement (GIS) in addition to Old Age Security and Canada Pension Plan benefits when they retire. They earn \$2,000 a year in interest income from their TFSA savings. Neither this income, nor any TFSA withdrawals, will affect the GIS benefits (or any other federal income-tested benefits and credits) they receive. If this \$2,000 were earned on an unregistered basis, it would reduce their GIS benefits by \$1,000.

Benefits for Seniors:

The TFSA will also provide seniors with a tax-free savings vehicle to meet ongoing savings needs, something they have only limited access to once they reach age 71 and are required to begin drawing down their registered retirement savings. Seniors are expected to receive one-half of the total benefits provided by the TFSA.

Savings for Post-Retirement Needs:

François and Evelyn are retired and living comfortably on François' pension. Evelyn also receives a small pension based on her years of work after raising their children. They would like to save Evelyn's pension each month and use it to spend the winter in Florida. The TFSA will provide them with an effective means to save for their trip south each year.

5 situations where a TFSA meets different needs

See which one fits you and how it could apply.

Flexibility Seeker:

Meg is a 40-year-old mother of two. While her employment income provides her with investable assets each year, she is reluctant to lock away the assets long-term for fear of unpredictable ad hoc expenses including home renovations and vehicle repairs. In the case of emergency, Meg wants ease of access to the funds, but still wants market exposure and the potential for higher rates of return. RRSPs are best used for long-term investing, so the debate for Meg would likely be TFSA versus non-registered investing. Said another way, the question would likely become *taxable* versus *non-taxable* investing. Because of the wide selection of investments available in the TFSA, and also because of the tax-free status of TFSA investment income, the TFSA would likely be the better option. As her TFSA increases in value over the years, Meg can use some of the funds to make RRSP contributions if she so desires.

Newer Investor:

Jimmy, age 23 and a new graduate, recently joined the workforce in his area of study. Like many new graduates, he is in a junior role and his income puts him in the lowest tax bracket. He expects to progress to higher tax brackets in the next few years. Because Jimmy still lives with his parents, his expenses are low. As a result, he has money available to invest. Jimmy can consider an RRSP for his long-term investments. Contributions to an RRSP would provide him with a tax-deferral on a portion of his employment income. However, if Jimmy thinks he may require the assets in a year when he is in a higher tax bracket, the TFSA might be a better option. Although a tax deduction would not be available at the time of contribution, future withdrawals (including income and capital gains earned) would be received tax free. This is in contrast to a fully taxable RRSP withdrawal – a withdrawal that would be taxed at the highest tax bracket he finds himself in at the time of withdrawal.

RRSP Maximizer:

Alex, a business owner, is able to maximize his RRSP each year. He is a fan of the RRSP primarily because of the annual tax deduction it provides. Because Alex is in the top tax bracket, he actively pursues legitimate tax shelters for the purpose of minimizing tax payable. Problem is, other than the RRSP, there are very few legitimate tax shelters available in Canada. Effective 2009, the TFSA is a new shelter available to Alex and one that can be used in combination with his RRSP. Because he is in the top tax bracket, tax deductions achieved by his annual RRSP contributions would likely continue to be of value. However, once his RRSP contribution limit is reached, excess funds can be invested in a TFSA for additional tax saving opportunities. Furthermore, the tax refund generated from his RRSP contributions can be used to further increase his TFSA contributions.

Income Splitter:

Dwight and Debra, ages 45 and 43, have been married for 15 years. Dwight is an electrician and Debra volunteers as a counselor in her community. Because Dwight is the primary income-earner (Debra earns some investment income from a small inheritance), he is taxed on the majority of the family's employment and investment income. For some time he has been seeking ways to split this taxable income with Debra, particularly because she is in a lower tax bracket. Spousal RRSPs have been used for long-term investments, but their nonregistered assets remain a concern.

The TFSA is a solution. Even though the family's income is earned primarily by Dwight, both Dwight and Debra will receive \$5,000 of TFSA contribution room each year. Unlike RRSPs, TFSA room is not based on income earned. Also, because spousal attribution rules (tax rules that prevent income splitting between spouses) do not apply to TFSA contributions, Dwight can contribute \$5,000 to his TFSA and give Debra \$5,000 to fund her TFSA allowing for tax-free growth on \$10,000 each year.

Satisfied Senior:

Allen is a 72-year-old RRIF annuitant who, because of tax legislation, must begin to receive RRIF payments by the end of the year. Allen does not require the extra cash flow as his annual expenses are minimal and he is adequately provided for by OAS, CPP and pension incomes. Allen would like to continue to invest the money received from his RRIF, but is concerned that additional investment income could result in a claw-back of income sensitive OAS benefits.

The TFSA can help. The cash flow received from Allen's RRIF can be reinvested in a TFSA. Unlike RRSPs, there is no age restriction for TFSA contributions and withdrawals, so seniors can benefit from the plan the same as any other investor.

Also, as opposed to being *tax-deferred* in the RRIF, future investment income will grow *tax-free* in the TFSA. Should Allen require cash from his TFSA thereafter, withdrawals can be made without any impact to his OAS benefits.

Coles Notes for TFSA

- Begins January 1, 2009 – you can set up the accounts now.
- \$5,000 per year for each Canadian resident age 18 and older.
- If you don't use the maximum amount you can use it later.
- There is no tax owing on any investment income (including interest, dividends and capital gains) earned in the TFSA.
- You can withdraw your money any time.
- The amount you withdraw from your account can be put back into a TFSA in the next calendar year.
- TFSA's can be used as collateral for a loan.
- Interest on money borrowed for TFSA use will not be tax-deductible
- Investments eligible for RRSPs will generally be eligible for TFSAs – this includes stocks, bonds and mutual funds.

We hope this document has been helpful. If you would like to talk further about TFSAs or set up a TFSA account, give your Singer Olfert advisor a call.
604-542-4298