

Tax-Free Savings Account (TFSA)

Overview of Product Features

Starting January 1, 2009, Canadian residents who are 18 years of age or older will be able to earn tax-free investment income within a Tax-Free Savings Account (TFSA) during their lifetime.

Contributions to a TFSA are not deductible for income tax purposes. Also, interest on money borrowed to invest in a TFSA is not tax deductible. However, the income generated in such an account (for example, investment income and capital gains) is tax-free, even when it is withdrawn.

The TFSA dollar limit is \$5,000 in 2009, and will be indexed to inflation and rounded to the nearest \$500 in later years. Unused TFSA contribution room can be carried forward to later years and will show on the members Notice of Assessment, alongside RRSP contribution room details.

The total of TFSA withdrawals in a calendar year is added to the TFSA contribution room for the next calendar year.

How the Tax-Free Savings Plan Works

Starting in 2009, you'll be able to contribute \$5,000 each year and each year following. You can open a plan if you're a Canadian resident, 18 and older and have filed a tax return.

This means that after 5 years, your contribution room will be \$25,000. If you don't contribute the \$5,000 in a particular year, this contribution room can be carried forward to future years – so you can play catch up if needed.

Unlike an RRSP, your contribution to a Tax-Free Savings Account is not tax deductible. However, the interest will not be taxed – so you get to keep what you earn.

You can contribute or withdraw funds at any time and for any reason without incurring taxes or a penalty (**Depending on the type of term it is invested in at your financial institution**). If you do take money out, you keep that contribution room and can put the money back in the Tax-Free Savings Account as soon as the following year.

NOTE: the holder (the member) is responsible for ensuring the maximum contribution limit is not exceeded. An excess contribution will result in a penalty tax of 1% per month for each month that the excess contribution amount remains in the TFSA.

The Tax-Free Savings Account will not affect your eligibility for income tested benefits, eg. Old Age Supplement, Canada Child Tax Benefit or Guaranteed Income Supplement – members are not penalized for saving.

Member FAQ

-Who do I contact for more information?

Nelson & District Credit Union (NDCU) is making preparations to offer the Tax-Free Savings Account effective January 1, 2009. Since the TFSA is not officially available until January 2009, we may not have all the answers yet, but we'll tell you what we know so far.

Not sure how the TFSA fits into your financial plan? Our knowledgeable and experienced financial guides can help. Visit www.nelsoncu.com often for up-to-date information. You can also visit your nearest branch or phone us.

- Nelson, 250-352-7207
- Rossland, 250-362-7393
- East Shore, 250-227-9221

-What is the Tax-Free Savings Account?

The TFSA is a registered savings account that allows taxpayers to earn investment income tax-free inside the account. Contributions to the account are not deductible for tax purposes, and withdrawals of contributions and earnings from the account are not taxable. TFSA savings can be used for a variety of needs, for example: to purchase a new car, renovate a house, start a small business or take a family vacation.

-When will it be available?

The Government of Canada proposes the TFSA will be available January 1, 2009.

-Who is eligible to open a TFSA?

Any individual (other than a trust) who is a resident of Canada and 18 years of age or older would be eligible to establish a TFSA. The only requirement will be that the individual must have a Social Insurance Number when the account is opened. There will be no limit on how many TFSAs each person can set up, keeping in mind that the allowable yearly tax-free contribution is a combined total of all of these accounts.

-How would I know what my TFSA contribution room is for a given tax year?

The Canada Revenue Agency (CRA) will determine TFSA contribution room (based on information provided by issuers) for each eligible individual who files an annual T1 individual income tax return.

Individuals who have not filed returns for prior years (because for example, there was no tax payable) would be permitted to establish their entitlement to

contribution room by filing a return for those years or by other means acceptable to the CRA.

-If I don't have the money to invest in a given year, would I be able to use any unused contribution room in a future year?

Yes, the 2008 budget proposes no limit on the number of years unused contribution room could be carried forward.

-How much can you contribute to a TFSA per year?

Each year you could contribute an amount up to your contribution room for the year. The TFSA contribution room will be determined by the CRA for each eligible individual who files an annual income tax return.

Your contribution room would be made up of three amounts:

- First: Each year you would be allocated and allowed to contribute at least \$5,000 (this annual amount will be indexed to inflation and rounded to the nearest \$500 on a yearly basis).
- Second: Any withdrawals made during the year would be added to the contribution room for the next year.
- Third: Any unused contribution room from the previous year would be added to the contribution room for the year.

For example (assuming no indexing):

In 2009 you would be allocated and allowed to contribute up to \$5,000. If you only contribute \$2,000, an amount of \$3,000 would be carried forward to 2010. Your contribution room for 2010 would then be \$5,000 plus \$3,000, or \$8,000. If in 2010, you do not contribute but decide to withdraw \$1,000, your contribution room for 2011 would be \$5,000, plus \$8,000 (carried forward from 2010), plus the \$1,000 withdrawn, or \$14,000.

-If I withdrawal can I re-contribute?

If you contribute the full \$5000 in the year and withdrawal any or the entire amount prior to the end of that same year any amounts re-contributed prior to the end of that same year will be considered an over contribution and will be taxed 1% per month for each month that excess contribution remains.

For example:

Let's say you transfer \$5,000, the maximum allowed, into your new TFSA at the beginning of 2009. Then, your \$5,000 grows to \$5,100, which you withdraw in July. You enjoy the fact that you will never have to pay income tax on your \$100 of interest, the most taxable form of investment income. You also like the idea that you can re-contribute the \$5,100 you withdrew. However, you will face a problem if you re-contribute to your TFSA too soon.

Suppose you eagerly start making monthly deposits in September in hopes of quickly rebuilding your \$5,100 balance. By making additional deposits to your TFSA in 2009 (after having already deposited the \$5,000 maximum at the start of the year), you will be penalized at the rate of one per cent per month on your "excess deposits."

To avoid penalties, you should wait until the following year to start TFSA re-contributions if you have already reached the maximum contribution limit earlier in the current year.

-What is the main benefit of saving in a TFSA?

Because capital gains and other investment income earned within a TFSA will not be taxed, an individual contributing \$200 a month to a TFSA for 20 years will accumulate about \$11,045 more in savings than if the investment had been made in a taxable savings vehicle (unregistered account).

Note: Combined federal-provincial tax savings, based on a \$200 monthly contribution for 20 years and a 5.5% rate of return. For unregistered savings, a 21% average tax rate on investment income's assumed (based on 40% interest, 30% dividends and 30% capital gains, and a middle-income earning account holder).

-Would there be any restrictions on withdrawals?

No, you could withdraw any amount in the account for any reason. **(depending on the type of investment ie: locked-in term may have conditions)**

-How can the TFSA help me with my savings need through my lifetime?

All Canadians have a reason to save to fulfill important lifetime goals and aspirations.

As you begin to work, you are able to contribute \$100 a month to your TFSA. By age 25, you have accumulated \$12,000—enough to purchase your first car for \$10,000.

You continue to save in your TFSA to finance other major purchases: a down payment on a new home, a home renovation to make it larger, a child's wedding and then an RV to enjoy in retirement.

By saving regularly in a TFSA throughout your life, you will be able to finance these purchases and still accumulate about \$135,000 by the time you are 80. This is about \$40,000 more than you would have accumulated had you saved on an unregistered basis.

-What kind of investments can you hold in a TFSA?

A TFSA would generally be permitted to hold the same investments as a registered retirement savings plan, such as:

- GICs, term deposits, high-interest savings accounts
- Mutual funds
- Shares
- Bonds, debentures, notes, mortgages
- Where a TFSA holds a non-qualified investment, a tax of 50% of the fair market value (FMV) of the non-qualified investment will be applied.

-What kinds of investments are prohibited for the TFSA?

You are not permitted to invest in entities where you do not deal at arm's length. Where a TFSA holds a prohibited investment, a tax of 50% of the fair market value (FMV) of the prohibited investment will be applied.

-What if I contribute excess amounts in my TFSA?

Similar to an RRSP, excess contributions to a TFSA will be subject to a 1% per month penalty tax until withdrawn.

-How will TFSAs be taxed?

The big advantage to the TFSA is that any income and gains on investments held within it will not be taxed either while held in a TFSA or upon withdrawal, hence the name – Tax-Free Savings Account.

-What if I borrow to invest in my TFSA?

Since the income earned inside a TFSA along with TFSA withdrawals are non-taxable, you will not be able to write off any interest expense on funds borrowed for the purpose of investing in a TFSA. Loan rates would be higher than investment rates so “no benefit”

-Could I use my TFSA assets as security for a loan?

Unlike RRSPs, which cannot be used as collateral for a loan (unless you want your RRSP deregistered and immediately taxed), TFSA assets can be used as collateral. This may facilitate investors in obtaining secured credit at more favorable rates.

-Can I give my spouse or partner funds to contribute to a TFSA?

Normally, the attribution rules contained in the Income Tax Act block attempts at splitting either income or capital gains between spouses or partners by attributing such income or gains back to the original spouse or partner.

The federal budget introduces an exception to the attribution rule stating that the rules will not apply to any income or gains earned in a TFSA derived from a spouse or partner's contributions.

-What is the effect on income-tested government benefits?

One of the biggest criticisms of the current RRSP system is that when funds are withdrawn upon retirement, not only are they taxed at the retiree's marginal tax rate, but in many cases the withdrawals affect the retiree's eligibility for income-

tested government benefits and credits. These may include the Age Credit, the Guaranteed Income Supplement (GIS) or even Old Age Security (OAS) benefits.

The Government of Canada announced that since withdrawals from the TFSA are not considered to be income, they will have no impact on government benefits or credits, such as GIS or OAS, or on the Canada Child.

-What happens upon death?

The fair market value of the TFSA on the date of death will be received by the estate on a tax-free basis, but an income or gains accruing after the date of death will be taxable.

Individuals will be able to name a surviving spouse or common-law partner as a successor account holder, in which case the TFSA will continue to be tax-exempt. Alternatively, the TFSA of a deceased individual can be transferred to the TFSA of a surviving spouse or partner.

-What happens upon separation or divorce?

On the breakdown of a marriage or a common-law partnership, any amount from the TFSA of one spouse or partner can be transferred to the TFSA of the other while maintaining the tax-exempt status. Note that the transfer will not re-instate the contribution room of the transferor spouse or partner, nor will it be counted against the contribution room of the transferee spouse or partner.

-What if you become a non-resident?

If you become a non-resident, you can still hold your TFSA and continue to benefit from the tax exemption on investment income and withdrawals, however:

- No contributions may be made to the TFSA, and
- TFSA contribution room will not accumulate while you are a non-resident.

-How is a TFSA different from a Registered Retirement Savings Plan (RRSP)?

An 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 TFSA contributions will not be deductible. Withdrawals from an RRSP are added to your income and taxed at current rates. Your TFSA withdrawals and growth within your account will not—they will be tax-free.

While the two plans are meant to be tax-neutral, RRSPs will tend to be the better choice when the tax rate upon withdrawal is expected to be lower than the tax rate upon original contribution. Conversely, TFSAs will make more sense if your tax rate (including the effect of RRSP withdrawals on reduced income-tested

benefits) will be higher upon ultimate withdrawal than it was when you contributed.

The 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.

-How do I find out if the TFSA is the right choice to meet my investment and savings goals?

Talk to your financial advisor at Nelson & District Credit Union. Your advisor can look at your entire portfolio; take into consideration your personal situation and goals, and recommend specific strategies.