The tax-free savings account
Essential for reaching your financial goals

NATIONAL BANK
FINANCIAL

Every Canadian age 18 or older can deposit up to $5,000 a year into a Tax-Free Savings Account (TFSA) to shelter these savings – and more importantly the returns they generate – from income tax. But whereas most tax shelters come with a wide assortment of limitations, the TFSA offers all of the versatility and flexibility that you could possibly want!

We are all familiar with the RRSP, or Registered Retirement Savings Plan, which allows us to save for retirement while deferring tax – this tax is eventually paid when the savings are withdrawn from the plan, usually upon retirement when marginal tax rates tend to fall. Although the **TFSA** hasn't been around for long, most tax practitioners and advisors see it as a perfect complement to the RRSP. Why? Because the TFSA is really tax free, rather than tax deferred. Also, when the TFSA is used in conjunction with an RRSP and taxable accounts, it opens up a broad range of very attractive possibilities.

If you are age 18 or older, you can deposit up to $5,000 per year in a TFSA, regardless of your earned income. This cash deposited into a TFSA can be used to purchase a wide variety of different investments – from simple GICs to

mutual funds, bonds, stocks, and even more sophisticated types of securities – which should be chosen based on your financial objectives, investor profile, and personal situation. Once invested in a TFSA, contributions grow without incurring any income tax on the returns, whether these returns are in the form of interest income, dividends or capital gains. Better still, when you wish to take money out of the account, you can do so in any amount at any time without paying any tax, and without ever having the obligation to put the amounts withdrawn back into the TFSA. Finally, when you do decide to draw down on what you have accumulated in your TFSA, every dollar you withdraw creates a dollar of new TFSA contribution room, which is added to the $5,000 you accrue at the beginning of each calendar year. This flexibility of use makes the TFSA an ideal complement to an RRSP because it lends itself more easily to saving for a wide variety of goals other than retirement – while still being entirely suited to retirement planning.

Interested? In this brochure we introduce:

* a few strategic ways of using a TFSA;
* the main features of the TFSA, especially as compared to an RRSP.

For more information, or if you have any questions, please talk to your advisor.

Strategies for using the TFSA
A multi-purpose tool.

The TFSA is a tax shelter that can be of great benefit to Canadian taxpayers, regardless of their wealth, age, or where they are in their lifetime financial cycle. Here are just a few of the ways to make strategic use of this type of account.

Putting money aside – where the taxman can't get it

Primary use: Since TFSA contributions are not dependent on earned income, and the contribution room is cumulative, the program can be used to shelter income earned on large cash inflows from sources other than employment: inheritances, lottery winnings, investment income, gifts, etc. The TFSA can also be used to save for a specific project, and is generally more flexible than other government programs such as the Home Buyers' Plan or Lifelong Learning Plan. When you withdraw money from your RRSP under either of these plans, you are tied to a fixed repayment schedule, failing which you must declare any outstanding amounts as taxable income. With the TFSA, you are under no obligation to replace any amounts you withdraw, but you still have the option of doing so, in whole or in part, at any time. This provides an attractive option for young couples saving for their first home, or for anyone who wants to fund a return to post-secondary studies.

Protect your investment income

Obviously, one of the more attractive applications of the TFSA is to shelter your investment returns from tax. Let's say, for example, that you use $5,000 in your TFSA to buy a carefully researched stock, and that the value of this stock skyrockets to $20,000 over the next 12 months. You sell, realizing a capital gain of $15,000. You can withdraw all of this capital gain from your TFSA without paying a cent in taxes. Better yet, the next year you will have $20,000 in contribution room – your usual $5,000 room for the new year plus the $15,000 you withdrew after selling your stock.

Split your retirement income – starting now

The TFSA can also be used as an income-splitting tool in conjunction with spousal RRSP contributions and the pension income-splitting rules that came into effect in 2007. Since TFSA withdrawals are entirely tax free and not subject to any attribution rules, this new program adds a powerful tool to your retirement planning toolbox.

Give the next generation a helping hand

Because there is no earned-income requirement, the TFSA is a great way for parents or grandparents to begin gradually transferring wealth to their children or grandchildren. The only restriction is that the child or grandchild must be at least 18 to have a TFSA and start accumulating contribution room. For instance, suppose that an 18 year-old entering university today is fortunate enough to be given a very generous $25,000 graduation present by her grandfather 5 years from now. Since our graduate has accumulated $25,000 of TFSA contribution (5 years X $5,000), she could transfer the full amount into her TFSA, and use it further down the road as a down-payment on a house, as seed money to start a business, or as a head start on saving for retirement.

Offset a restrictive pension adjustment factor

If you participate in an employer-sponsored pension plan, you already know that this plan gives rise to a pension adjustment factor that limits the amount you can contribute to your RRSP each year. The TFSA allows you to partially circumvent this obstacle and save an additional $5,000 per year that will accumulate on a tax-sheltered basis. Even though TFSA contributions are not tax deductible, the effect of tax-sheltered compounding is the same and, as we show later with a numerical example (see p. 10), will result in an identical net amount of retirement income as an RRSP contribution, assuming the same marginal tax rate at the time of the contribution and the withdrawal.

Build an addition to your RRSP room

The same principle holds if your income is such that you are already maximizing your RRSP contribution ($20,000 in 2008, $21,000 in 2009, etc.) and could afford to put more away if it wasn't for the legislated contribution cap. The TFSA gives you a vehicle in which to save up to an additional $5,000 annually on a tax-sheltered basis.

This is an important point given that high-income earners cannot count exclusively on either the government or their RRSPs to maintain their standard of living when they retire. Our country's tax-sheltered RRSP and pension system is based on the belief that a Canadian should be able to retire after 35 years of work at 70% of his or her final salary. To help achieve that, we are allowed to invest 18% of earned income on a tax-deferred basis through an RRSP or

workplace pension plan, or both. But this allowance is capped by a dollar limit that was designed to meet the retirement funding needs of "typical" Canadians: i.e. those earning no more than about 2.5 times the average national wage. For example, 2008's tax-sheltered savings limit of $20,000 applied to those who had earned $111,111 in 2007. That's roughly 2.5 times that year's $44,900 average wage. The maximum RRSP contribution for 2009 – $21,000 – covers $116,667 in 2008 earned income.

This dollar cap keeps the RRSP/pension program affordable for government and meets the needs of most Canadians. However, it does not provide enough tax sheltering for the highly paid to fund a 70% income replacement ratio at retirement – especially for the self-employed who typically lack workplace pensions. Until now, people in this situation had to use taxable investments to cover the shortfall.

If you are in this position, the new TFSA enables you to take $5,000 that would have gone into taxable investing and instead allow it to grow on a tax-free basis. Suppose you invest $5,000 in a TFSA every year for 20 years. Assuming an average compound annual return of 6%, your TFSA would grow to roughly $195,000 over that period. This would fund just over $10,000 of tax-free annual retirement income for 35 years, indexed for 2% inflation.

Plus, as we will discuss further on (see p. 12), replacing taxable RRSP or RRIF withdrawals with tax-free TFSA cash flow might enable you to avoid part or all of the Old Age Security clawback and collect OAS benefits that would otherwise have been lost.

What to invest where?

Optimizing the allocation of your investments between an RRSP, a TFSA and your taxable investment account will depend on your personal situation, so be sure to consult your advisor before investing your contributions.

At first glance, the TFSA is ideal for interest-bearing vehicles that would otherwise be fully taxed, strip bonds that face onerous taxation if held outside a registered plan, and foreign stocks whose dividends are fully taxed as income. But you might find it better to keep those securities in the tax-sheltered RRSP and use the TFSA for those investments which you expect to produce the highest returns – typically equities. This way, the greater accumulation will face no tax on withdrawal.

Here's an illustration. Suppose you put $5,000 into a strip bond that will compound at 6% a year for 20 years and $5,000 into an equity mutual fund that's expected to average 8% annually over the same period. Both investments are then liquidated and withdrawn as cash, with the RRSP withdrawal taxed at 48%. As the following table shows, the two scenarios have quite different outcomes:

Where to put it?

In the RRSP	In the TFSA	Tax on RRSP withdrawal	Net after-tax Income: RRSP + TFSA
Strip bond	Equity fund	$ 7,697	$ 31,643
Equity fund	Strip bond	$ 11,186	$ 28,154

Other considerations

Anyone required to file a U.S. income tax return should consult his or her professional tax advisor about the status of TFSA earnings and withdrawals. At present, there is no cross-border provision that recognizes the TFSA shelter for U.S. tax purposes.

TFSA at a glance
RRSP or TFSA? … Why not both!

The best way to fully understand the TFSA is to compare it with the RRSP, a tax-deferral program familiar to all taxpayers. While the two accounts are similar in many ways, there are a number of significant differences, too.

Like the RRSP, the TFSA is a savings vehicle that shelters your savings from income tax, thus allowing them to grow much more quickly towards a given project – financing your retirement, for example. However, the two programs differ in how they work, and in some specific provisions.

Contributions and withdrawals

Amounts contributed to a TFSA are not tax deductible, whereas each dollar contributed to an RRSP reduces your taxable income by exactly one dollar, lowering your tax bill in the process. On the other hand, withdrawals from a TFSA are tax free, whereas amounts withdrawn from an RRSP or RRIF are fully taxed at your marginal rate. Thus:

* with an RRSP you effectively contribute pre-tax income and pay tax on withdrawals;
* with a TFSA, you are contributing after-tax dollars but the withdrawals are tax free.

Does this matter? Not at all... or a whole lot, depending on your tax situation when you contribute and when you make your withdrawals. You need to consider two main factors:

* your marginal tax rate – when contributing and when withdrawing, and
* how a withdrawal will affect any benefits you could be receiving from means-tested government programs, such as Old Age Security (OAS).

Marginal tax rate effect

Your preference for a TFSA or an RRSP will depend on the difference between your marginal tax rates at the time you make your contribution and when you ultimately make your withdrawal:

* if your tax rate is the same when you make your withdrawal, the two programs offer exactly the same advantages over a taxable savings or investment account, as shown in the table below:

Comparing the TFSA and RRSP to taxable savings

	TFSA	RRSP	Taxable account
Pre-tax income	$1,000	$1,000	$1,000
Tax (assumption: 40%)	$ 400	–	$ 400
Net contribution	$ 600	$1,000	$ 600
Investment income (assumption: 20 years, 5.5% gross return)	$ 1,151	$ 1,918	$ 707
Accumulation (net contribution + investment income)	$ 1,751	$ 2,918	$ 1,307
Tax on withdrawal (assumption: 40%)	–	$ 1,167	–
Net amount remaining	$ 1,751	$ 1,751	$ 1,307

Note: In the case of the taxable account, net investment returns were calculated assuming a 5.5% gross return and an average weighted tax rate of 28%, corresponding to a diversified portfolio where the returns are composed of 30% dividends, 30% capital gains, and 40% interest income.

Source: Department of Finance Canada

* If your marginal tax rate will be lower by the time you make your withdrawal, the RRSP is a more attractive option because the tax saving realized on your contribution is larger than the tax liability you will pay on your withdrawal;
* However, if your marginal tax rate will be higher when the funds are withdrawn than it was when you made the contribution, the TFSA is more attractive than the RRSP.

To understand these issues better, let's make three assumptions. First, your marginal tax rate is currently 48%. Second, you put $5,000 into a TFSA and $9,615 into an RRSP (that's $5,000 of out-of-pocket cash for the RRSP plus the related tax savings). Third, you make the same investments in both plans, generating an average compound annual growth of 6% for 20 years. Here is the "in your pocket" spendable income generated under three scenarios:

Tax on withdrawal

Marginal tax rate at time of contribution	Marginal tax rate at time of withdrawal	Net amount received at withdrawal	
		RRSP	TFSA
48%	48%	$ 16,036	$ 16,036
48%	52%	$ 14,802	$ 16,036
48%	44%	$ 17,269	$ 16,036

As we can see, the RRSP and the TFSA produce exactly the same amount of spending money if the tax rate on your RRSP withdrawal is the same as your marginal rate when you made the contribution. But the RRSP is the less attractive option if your marginal tax rate will be higher at the time of withdrawal, and the more attractive option if it will be lower.

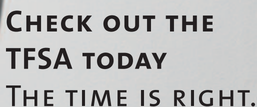
Impact of the clawback

Your eligibility for certain government benefits programs is based on your financial means, or level of income – which is why such programs are referred to as means-tested. The most obvious case is the Old Age Security (OAS) benefit that Canadian citizens become entitled to when they turn 65: OAS payments are reduced by 15 cents for each additional dollar of taxable income from other sources you earn above a certain threshold. This is known as the "clawback threshold" (in 2008, the threshold was $64,718; it is fully indexed to inflation). As a result, you lose $150 of OAS for every $1,000 by which your taxable retirement income exceeds this threshold.

In practice, this means that if your marginal tax rate in retirement is 48%, you would have to withdraw $1,923 from your RRSP to net $1,000 for spending, and since this $1,923 withdrawal is taxable income, it would reduce your OAS by $288. If instead you made your withdrawal from a TFSA, a $1,000 withdrawal would leave you with $1,000 in spending money – and with no loss of OAS benefits. So, even if your marginal tax rate during retirement will be the same as now or lower, you can still come out ahead by having a TFSA in addition to your RRSP and/or workplace pension plan.

Also, you must convert your RRSP to a RRIF or annuity by the end of the year in which you turn 71, and begin making taxable withdrawals the following year even if you don't need the money – and this additional income will increase OAS clawback exposure. However, there are no mandatory withdrawals for TFSAs, and withdrawals are not considered as taxable income.

Alternatively, once retired, you could consider keeping the TFSA as a reserve to fund big expenses such as purchasing a new car or funding a big trip. Pulling out enough RRSP or RRIF money to cover such purchases could easily boost the year's income high enough to eliminate most if not all of your OAS benefits, but using your TFSA money would have no impact on your OAS eligibility.



Check out the TFSA today

The time is right.

The TFSA has garnered a lot of attention, for all the right reasons. So be sure to make the most of it!

The TFSA offers a great many advantages. Which ones are right for your situation and best suit your needs?

* being able to earn investment returns entirely sheltered from tax?
* being able to access your capital and investment returns at any time without tax or penalty?
* transferring your assets to your heirs tax free?
* making a tax-free spousal rollover on death?
* being able to carry forward your unused contribution room from year to year?
* being able to withdraw money after retirement without having your Old Age Security benefits clawed back?
* being able to continue using this tax shelter regardless of your age?
* or any other reason related to your personal objectives?

No matter what your situation, your advisor will be an invaluable partner in helping you to get the most out of the TFSA by integrating it into your overall planning. We invite you to contact him/her for a detailed discussion of all aspects of a TFSA that could be advantageous to you and your family.

Summing it up

The following table summarizes the main similarities and differences between the TFSA and the RRSP.

Comparing the TFSA and RRSP

Who is eligible?
Allowable annual contribution
Indexation
Is contribution tax deductible?
Are spousal contributions allowed?
Is unused room carried forward?
Is there a penalty on excess contributions?
Is growth tax sheltered?
What are allowable investments?
Are withdrawals taxed?
Must you start withdrawals after age 71?
Can withdrawals be returned to the account?
Do withdrawals affect income-tested government benefits?
Is there a tax-free spousal rollover on marital breakdown or at death?
Upon death, is plan taxed as final year's income if no rollover beneficiary?
If financed with a loan, is the interest tax deductible?
Can account be used as loan collateral?
Is the account protected from creditors under federal Bankruptcy Act?

RRSP	TFSA
Anyone age 71 or younger with earned income in the prior year (subject to pension adjustment)	Anyone age 18 or older – even if past the RRSP maturity age of 71
Up to $20,000 for 2008, $21,000 for 2009 and $22,000 for 2010, based on earned income and pension plan membership	$5,000 in 2009
Indexed to Average Industrial Wage	Indexed to Consumer Price Index, rounded to nearest $500
Yes	No
Yes	No, but one spouse can give the other the funds required for his/her contribution, without being subject to income attribution rules
Yes	Yes
Yes: 1% per month if excess contributions are more than $2,000	Yes: 1% per month
Yes	Yes
Very wide range	Similar to RRSP investment rules
Yes	No
Yes	No
Only if made under the Homebuyers' Plan or Lifelong Learning Plan	Yes
Yes	No
Yes	Yes
Yes	No
No	No
Not normally advisable	Yes
Yes, with the exception of contributions made within 12 months of declaring bankruptcy	No

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