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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Strategies to incorporate the tax-free savings account (TFSA) into your financial plan

This article discusses the flexibility of a TFSA and how it can be leveraged throughout different life stages based on your financial priorities.

Any reference to a spouse in this article also includes a common-law partner.

Overview

TFSAs are a type of registered plan, and like all registered plans, your contributions grow inside the plan without attracting tax. Contributions are limited to an annual maximum with unused room being carried forward indefinitely. Contributions are not tax deductible but, funds can be withdrawn from your TFSA tax-free at any time. On withdrawal, the full fair market value of your TFSA withdrawal can be recontributed the following calendar year (assuming you were not over-contributed). TFSAs can be used for a wide range of goals — from emergency savings, to renovations, to supplementing your retirement income. There are also some opportunities to income split to reduce the overall household income tax bill.

Income-splitting opportunities

Gifts to a spouse

If there's a higher-income spouse and a lower-income spouse in your household, you may be able to benefit from income-splitting using the TFSA.

When a higher-income spouse provides funds to their lower-income spouse to contribute to their TFSA, any income or capital gains earned on those funds while they are held in the TFSA will not attribute back to the higher-income spouse, provided the contribution doesn't result in (or add to) an over-contribution. Plus, as the funds in the account accumulate tax-free, there's no impact on any spousal tax credits that the higher-income spouse may be able to claim.



When you gift funds to your spouse to invest in their TFSA, both you and your spouse can earn tax-free investment income, irrespective of which spouse provided the funds. The TFSA allows tax-free growth on the funds in the account, so there's greater potential for investment growth as the contributions made by each spouse builds over time.

It's also worth noting that if you have a lower-income spouse who has little or no earned income with which to build registered retirement savings plan (RRSP) contribution room, they can accumulate retirement savings using their annual TFSA contribution room, which will continue to accrue throughout their lifetime whether or not they have earned income.

Gifts to adult children

If you gift funds to a child who's at least 18 years old, they can use these funds to contribute to their own TFSA. This may be a good income-splitting strategy to consider when you've maxed out your own TFSA contribution room and have excess non-registered funds. The attribution rules won't apply to income and capital gains earned on the gifted funds, and instead of that income and capital gains being taxed in your hands, it can grow tax-free in your child's hands. However, it's important to note that once you make the gift, you'll no longer be able to control how the funds are invested, when and how much is withdrawn or how the funds are used.

Please note that in certain provinces and territories, the age of majority is 19. In these jurisdictions, a person who is 18 will accumulate TFSA contribution room for the year but will not be able to open the TFSA until they reach age of majority.

Opportunities for retirees

Retirees may be one of the major groups who stand to benefit from the TFSA. Here's a summary of some of the potential opportunities:

- If you're no longer working but have excess cash flow, you can continue building your savings through TFSA contributions, even though you no longer have earned income with which to generate new RRSP contribution room. You can withdraw funds from your TFSA when you need them and re-contribute them without tax consequences in the following year.
- You can contribute to a TFSA even after the end of the year you turn 71, when you're no longer able to contribute to your RRSP. This feature means you'll be able to preserve some tax-free growth, and you won't be required to convert the TFSA to an income paying vehicle at any time in the future.

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- If you anticipate being in the same or a higher marginal tax bracket in retirement, a TFSA may provide another source of tax-efficient retirement income. Unlike withdrawals from an RRSP or registered retirement income fund (RRIF), which are fully taxed at your marginal tax rate, withdrawals from a TFSA are not taxable.
- Another advantage of using a TFSA to complement your existing sources of retirement income is that withdrawals do not have an impact on any federal income-tested benefits and credits you may receive. A couple of examples of federal income-tested benefits are the old age security (OAS) and the age amount.

Complementing your existing registered savings plans

Depending on your financial circumstances, and your stage of life, you may be able to use the TFSA to complement your existing registered savings plans:

- If you have RRSP contribution room, consider making a contribution and using the tax refund you receive to contribute to a TFSA. This could be a way to save for various goals (for example, a home, a car or travel) while sheltering income from taxation.
- You may want to consider using your TFSA to accumulate funds in addition to an RESP. This could be another tax-sheltered way to save for a child's education. By using your own TFSA, you can start investing long before your child is able to open their own account, and you can withdraw funds tax-free when they're needed.
- If you have investments in non-registered accounts, consider contributing them in-kind to your TFSA, up to your allowable TFSA contribution limit. Keep in mind that this could trigger capital gains, which may result in an immediate tax liability, but future income and growth on these investments will be tax-free. Also, if the investments are in a loss position, you will not be able to claim the capital loss.

- If you're unable to fund both an RRSP and a TFSA during your peak earning years when you're in a higher tax bracket, contributing to your RRSP may make sense to give you the benefit of the income tax deduction. You could then withdraw the funds from your RRSP when you're in a lower tax bracket, possibly in retirement, and contribute it to a TFSA to generate tax-free investment income that you can access whenever you need it.

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Creating an emergency fund

You may want to use the TFSA to help create an emergency fund. If you do, remember that because these funds may be needed urgently, you may wish to consider investing in more secure, less volatile interest-earning securities that are more likely to hold their value. In addition, because interest income in a non-registered account is not taxed favourably, compared with Canadian dividend income and capital gains, the TFSA may be a great place to shelter your investments that produce interest income. You could earn interest income on the funds tax-free and have access to them when you need them. You may also want to consider using your TFSA as a complement to a line of credit as another way to meet unexpected expenses.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

Summary

The TFSA offers flexibility in saving and investing throughout your lifetime and can provide a source of income in retirement. If you make the maximum contribution to your RRSP every year and are looking for additional ways to shelter investment income and capital gains from taxation, a TFSA can be a great complement, even though you won't receive a tax deduction for your contributions.



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