

COMMENT

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TFSA – A Term Worth Knowing

Coming soon to a financial institution near you – the tax-free savings account (TFSA)! While it may sound somewhat technical, in reality it is a simple savings vehicle introduced by Finance Minister Jim Flaherty in his February 25, 2008, federal budget. And the benefits of understanding this new savings opportunity are worth a quick read.

Beginning in 2009, individuals age 18 and older can invest up to \$5,000 annually into a TFSA. The \$5,000 annual room is not calculated on or limited by the individual's



income. While the contribution into the plan will not be tax deductible, all investment earnings will accumulate tax free and the withdrawal will also be tax free. In other words, there is now an opportunity to accumulate and then spend investment income without attracting tax on those earnings. The compounding impact will allow funds to grow exponentially as investment income can be reinvested and continue to earn income tax free. The TFSA will not be limited to interest-only types of savings, but will also

provide for other types of investment earnings, including capital gains and dividend income.

The accompanying chart demonstrates the long-term value of investing without the cost of taxation dragging down the value of an investment.

In this example, the participant deposits \$5,000 per year into a regular savings account and the new tax-free savings account where each account earns five per cent interest income per year. Each year, the income tax payable on interest earned in the regular savings account is withdrawn from that account. At the end of 15 years, the TFSA is \$19,468 ahead of a regular non-registered investment. The advantage is derived by avoiding \$15,398 of income taxes paid on the annual income of the non-registered plan and \$4,069 of extra compound growth because income taxes did not reduce the account balance.

The type of investment income earned is important because it affects how much tax will be avoided. However, in reality, the new TFSA will always have the advantage over non-registered savings. If the taxpayer has a choice of where he or she holds investments (i.e., TFSA, registered retirement savings plan (RRSP) or non-registered accounts) because of the magnitude of his or her total portfolio, equities would generally be held personally as non-registered investments and interest-bearing investments would be better off held in a TFSA or RRSP.

| Type of Investment Income | Effective Tax Rate | Tax Under TFSA |
|---------------------------|--------------------|----------------|
| Interest income | 45% | 0% |
| Eligible dividend income | 25% | 0% |
| Capital gain | 23% | 0% |

The nature of this new plan creates a tax-free zone with widespread appeal from which all Canadians can benefit. As long as they have the financial wherewithal to save money, the account is available to all Canadians regardless of income level. In the past, investment income earned, even interest received in a simple bank account, created an immediate potential clawback for Old Age Security (OAS) recipients and low-income individuals receiving the Guaranteed Income Supplement. While lower-income people may not have a lot left over to place in savings vehicles, the TFSA eliminates what was previously a disincentive to save, as individuals will no longer be penalized from the first dollar of savings. Seniors, for example, typically do not have earned income that can be sheltered by contributing to a RRSP once they leave the workforce. The TFSA will allow for new sheltering opportunities that may appear modest initially, but a systematic approach to savings will bode well for those who otherwise would be paying tax on the income.

It has been over 50 years since RRSPs made their debut. The new TFSA is not intended to replace the RRSP, but rather it broadens tax-preferred savings opportunities and is designed to encourage greater savings amongst Canadians. Every eligible Canadian with any type of savings will want to consider the TFSA. The information outlined here is based on details outlined in the initial federal government announcement. As the government prepares supporting legislation and drafts regulations, aspects will become clearer. The 2009 implementation date was selected to allow financial institutions time to design their version of the product and create systems and infrastructure in order to sell and administer the new TFSA. It is anticipated that the structure of the TFSA will be generic in nature; however, the bells and whistles, such as investment options, fees and withdrawal penalties, will differ by financial institution.

As already noted, the TFSA is not intended to replace the RRSP. RRSPs are for retirement savings while the TFSA is designed for short- to medium-term savings. If an RRSP could be used efficiently for short- to medium-term savings, most taxpayers would be numerically indifferent between RRSPs and TFSAs. The reason is that \$5,000 deposited into

a TFSA would grow to \$5,250 by the end of the first year (assuming a five per cent rate of return). Similarly, if \$9,091 were contributed to an RRSP by someone with a 45 per cent marginal tax rate, that individual would receive a tax break on the contribution equal to \$4,091, leaving him or her out of pocket by \$5,000. At the end of the first year, the \$9,091 RRSP would grow to \$9,545 (assuming the same five per cent rate of return). The after-tax value of a \$9,545 RRSP would be \$5,250, the same as that available under the TFSA. If the marginal tax rate differs between the time of the contribution and the time of withdrawal, however, the results between the two plans would also differ.

While TFSAs are still nearly a year away from implementation, planning ideas are starting to emerge, which is important because taxpayers will want to be in a position to implement new strategies as soon as legislatively possible. While not fully vetted under the new rules, the following potential planning strategies are starting to emerge:

- Taxpayers will want to utilize a combination of RRSP and TFSA in order to better plan retirement. Low-income clients will be able to retain more government benefits. Middle-income clients will be able to better minimize income taxes. High-income clients will be able to have more tax-preferred savings available.
- Taxpayers will want to try to start funding plans for their children as soon as they reach age 18 in order to take advantage of the long-term compounding available. Just like an RRSP, the magic of compounding is far better than the ability to carry forward deposit room.
- Seniors will want to systematically move a portion of their investments into a TFSA to avoid tax on the accumulation and reduce the potential OAS clawback.
- Strip bonds may emerge as one of the ideal investments for a TFSA because of the interest treatment of the investment.
- Adults without long-term investments will be able to park emergency funds in these accounts because funds may be withdrawn and redeposited outside the annual \$5,000 investment limit.

For now, taxpayers will want to keep their eye on any non-registered reinvestments coming due in the fall of 2008 to keep \$5,000 per adult liquid for a January investment in the new TFSA to ensure the realization of the maximum benefit of this new savings vehicle.

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Government Pension Plans: Benefits and Contributions For 2008

Contributions and benefits under government pension plans are adjusted periodically to reflect increases in the consumer price index or the average Canadian wage. The new amounts, commencing January 1, 2008, are shown in the table

below. Each benefit is subject to income tax when received, with the exception of the Guaranteed Income Supplement and the Allowance. All benefits shown are paid monthly unless otherwise indicated and are the maximum amounts.

| | CPP | QPP | OAS |
|---|------------|------------|------------|
| CPP/QPP benefits (for new beneficiaries) | | | |
| Retirement pension (at age 65) | \$884.58 | \$884.58 | |
| Disability pension | \$1,077.52 | \$1,077.49 | |
| Disabled contributor's child benefit (each child) | *\$208.77 | *\$66.29 | |
| Survivor's*** pension | | | |
| • under age 65 | **\$493.28 | **\$745.77 | |
| • age 65 or over | \$530.75 | \$530.75 | |
| Surviving child's benefit (each child) | *\$208.77 | *\$66.29 | |
| Death benefit (lump sum) | \$2,500.00 | \$2,500.00 | |
| Combined benefits | | | |
| • survivor's*** pension and disability (under age 65) | \$1,077.52 | n/a | |
| • survivor's*** pension and retirement (age 65 and over) | \$884.58 | \$884.58 | |
| Annual CPP/QPP contribution | | | |
| Self-employed (9.9%) | \$4,098.60 | \$4,098.60 | |
| Employee (matched by employer) (4.95%) | \$2,049.30 | \$2,049.30 | |
| Old Age Security (OAS) | | | |
| January to March 2008 | | | \$502.31 |
| Guaranteed Income Supplement (GIS) | | | |
| January to March 2008 | | | |
| • spouse/common-law partner receives OAS or Allowance | | | \$418.69 |
| • single person (or spouse/common-law partner receives neither OAS nor Allowance) | | | \$634.02 |
| Allowance | | | |
| January to March 2008 | | | |
| • age 60 to 64, and spouse/common-law partner receives OAS and GIS | | | \$921.00 |
| • age 60 to 64, survivor's*** Allowance | | | \$1,020.91 |

Notes:

* flat benefit amounts

** these amounts may vary depending on whether the survivor is under age 45, disabled, or with or without children

*** a survivor is the spouse or common-law partner of a deceased individual

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Tax Tips - Filing Your 2007 Income Tax Return

The following are a few tax tips related to new opportunities or commonly overlooked areas that could save taxes when completing your 2007 income tax return.

One of the new high-profile tax savings opportunities available for the first time in 2007 is accessible to married and common-law couples who have eligible pension income, which can now be split between them. The split is only for tax purposes and the objective is to lower the overall tax liability of the couple. Pension income is more narrowly defined for the purpose of this benefit than what one might immediately think. For individuals who prepare their own income tax returns using commercial tax software packages, be cautious as this strategy has not been programmed by all of the software companies and will not necessarily be calculated automatically, nor to the maximum advantage. However, it should be noted that the calculation can be done manually as long as the proper form is filed with the income tax returns. In many cases, the user will need to play with the eligible pension numbers to strike the ideal split that achieves optimal tax savings and minimizes clawbacks. Lastly, it should be noted that an election to split pension income will not always derive an overall tax savings for the couple – the results depend on their specific circumstances.

If one spouse in a married or common-law relationship earned total income of less than \$9,600, the higher-income spouse may be able to claim a tax credit in respect of the lower-income spouse. The amount of the credit will be adjusted to reflect any income earned by the lower income spouse up to \$9,600. This is not a new tax savings opportunity, but the credit has increased (from a maximum of \$7,505 in 2006 to \$9,600 in 2007) and the income threshold has been simplified.

There may be an opportunity to enhance the spousal tax credit if the lower-income spouse has dividend income from a taxable Canadian corporation. This income may be shifted to the higher-income spouse if the outcome of such a shift would

allow the lower-income spouse to be claimed for the spousal tax credit amount or if the shift would increase the amount of that claim. The strategy focuses on reducing the lower-income spouse's income and, therefore, increasing the amount of the spousal tax credit available to the higher-income spouse. It also avoids wasting a non-refundable dividend tax credit in the hands of the lower-income spouse. A transfer of dividend income from a taxable Canadian corporation is permitted only if all such income is transferred from one spouse to the other.

Each dependent child born in 1990 or later may provide a tax credit of \$2,000 for the taxpayer or the taxpayer's spouse. The full credit is available in the year of birth, adoption and death. All or part of this credit can be transferred between spouses. If the child resides with both parents, either parent may claim the tax credit. There are rules that define how the amount is to be allocated if the child does not live with both parents.

The new children's fitness amount allows the taxpayer a tax credit claim of up to \$500 per child in respect of fees related to registering the taxpayer's child, or his/her spouse's child, in a prescribed fitness program. The child must have been under age 16 on January 1st of 2007. Additional amounts may be available for children with disabilities and the age limit is extended to age 18 for these children.

Expenses paid in respect of monthly and longer-duration passes for travel on public transit within Canada are now eligible for tax credit. There are specific guidelines with respect to the types of passes that qualify and the types of receipts required.

No one wants to pay more taxes than required, so keeping a keen eye on potential savings and checking particulars relative to your personal circumstances will help minimize taxes in your family unit.

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