DECISIONS, DECISIONS …

Making the most of your TFSA dollars

Now that we have a new savings vehicle – the Tax-Free Savings Account (TFSA) – it's time to consider if you can benefit from it. Provided that you have no credit card debt, TFSAs may be the investment of choice for the first $5,000[1] of any non-RRSP savings each year. Here are some factors to consider.

CHOOSING INVESTMENTS

Even though it's called a savings account, you can establish a TFSA at most financial institutions – not just banks. Since TFSAs do not benefit from the tax-efficiency of dividends or capital gains, it is generally a good idea to use them for the least tax-efficient investments, such as those that pay interest. On the other hand, depending on your risk tolerance, you may wish to invest your TFSA dollars in higher-risk investments with the hope that a $5,000 deposit will grow significantly. You will be able to withdraw any growth tax-free – but keep in mind that if the investment does poorly you won't be able to deduct any capital losses.

TFSA, RRSP OR BOTH?

The right choice for you may depend on your income level. Let's consider strategies for people with low, middle and high incomes.

LOW INCOME

For low-income Canadians, a TFSA may be more suitable than an RRSP. If you previously made RRSP contributions and now find yourself in a lower tax bracket – for example, while you are on parental leave – you may want to consider withdrawing $5,000 from your RRSP to make a TFSA contribution.

MIDDLE INCOME

One strategy for middle-income earners is to contribute to your TFSA now and accumulate RRSP room. You will be able to use that RRSP room later on, when you're in a higher tax bracket, to optimize the tax benefits. Rainy day or emergency savings are also appropriate for a TFSA.

HIGH INCOME

High-income Canadians may want to maximize both their RRSP and TFSA contributions. In fact, you can use the tax savings or tax refund you receive based on your RRSP contribution to fund your TFSA.

GRADUALLY TRANSFERRING OTHER ASSETS TO A TFSA

You may want to consider withdrawing $5,000[1] per year from non-registered accounts and contributing that sum to your TFSA. Guaranteed Interest Contracts (GICs), for example, where you pay tax on the interest on an ongoing basis, may be an ideal asset to switch to a TFSA. That way, you can allow future interest to accumulate tax-free.

You may also want to consider transferring market-based assets, such as mutual funds or segregated funds, from a non-registered account to a TFSA. Or, if you are concerned that you will lose income-tested benefits in retirement, you could withdraw from your RRSP during your working years to gradually transfer funds to your TFSA. The tax you pay

[1]Or the indexed amount.

now may very well offset the impact of reduced benefits in retirement.

Remember that if you are transferring market-based assets in kind to a TFSA, it will trigger a capital gain or capital loss but any capital loss will be denied. So, if you are in a loss position, it may be better to sell the investment and trigger the loss and then contribute the cash to the TFSA. However, if you want to buy the same investment inside the TFSA wait 30 days before doing so, otherwise your capital loss will be denied.

INCOME SPLITTING

Every Canadian who is 18 or older starts accumulating TFSA room. However, not everyone has the means to make a TFSA contribution. You may want to provide the funds to your spouse or adult children for a TFSA contribution. This will have no tax consequences for you, and allows an increased amount of your combined investments to grow on a tax-free basis.

PLANNING FOR RETIREMENT

You can use a TFSA to supplement your retirement savings if you are in a situation in which you can't contribute to an RRSP. For example, you may receive dividend income rather than earned income, or you may belong to a pension plan where the pension adjustment limits your RRSP contribution.

SAVING FOR EDUCATION

A TFSA is not a replacement for a Registered Education Savings Plan (RESP) for education savings, because a TFSA does not offer the RESP benefits of Canada Education Savings Grants (CESGs). In addition, the holder of a TFSA must be at least 18 years old. However, you could help older children – for example, those in university – by providing funds so they can start their own TFSAs. Alternatively, you could use your own TFSA savings to meet the high cost of education when RESP savings are not enough.

SAVING FOR A FIRST HOME

If you are saving for a down payment on a house, a TFSA might be a better option than saving in an RRSP and withdrawing under the Home Buyers' Plan (HBP).

There are several reasons for this:

- A TFSA offers the flexibility to recontribute withdrawals without time limits; if HBP repayments are not made on time, the annual repayment amount is added to your income and any missed repayment amount means the RRSP room is lost forever
- There are no restrictions on the amount you can withdraw from your TFSA, while the HBP restricts you to $25,000 from your RRSP and $25,000 from your spouse's RRSP. With a TFSA, as just one example, you could each contribute $5,000 a year for five years and then each withdraw $25,000 plus any investment earnings tax-free, with no required repayments
- There are no conditions on TFSA withdrawals, whereas the HBP requires you to be a first-time home buyer

Similar reasoning applies to the Lifelong Learning Plan (LLP). By using a TFSA to save for and fund continuing education, contributors gain increased withdrawal flexibility, while eliminating enrollment requirements and repayment conditions. •

Whether you decide to save in a TFSA, RRSP or both may depend on your savings needs, your eligibility for income-tested benefits and your current and expected future financial situation and income level. Speak with your advisor, who can help you evaluate what the best choices may be for you.

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