AIC TAX SMART

BULLETIN

Tax-Free Savings Account – Basic Strategies

TAX-SMART INVESTING®

In a country like Canada, where taxes can be almost 50% of your taxable income, saving taxes always should be a priority.

At AIC, our investment approach incorporates tax planning to minimize your investment tax bill each year. This approach to maximize your after-tax returns is evidenced by our commitment to tax-smart education, a strong corporate philosophy grounded in tax minimization, and our tax-smart investment products.

A tax-smart portfolio is one that focuses upon maximizing after-tax investment returns. After all, it's not how much you earn, but how much you keep, that matters most.

AIC believes in maximizing after-tax wealth (i.e. your bottom-line cash flow). We're proud of being Canada's tax-smart investment manager and a committed educator of Canadians in matters of investing, tax planning and an integrated tax-smart investment approach.

This bulletin is one in a series about tax-smart investing. We believe you'll find this bulletin, along with our tax-smart investment products, helpful in maximizing the value of your taxable investment portfolio.

Get ready for a new way to grow your savings

Starting in January 2009, you'll have another great way to grow your savings. With the introduction of the new Tax-Free Savings Account (TFSA) by the Federal Government, Canadian residents will be able to contribute to a TFSA without being taxed on investment income or capital gains. While there's no tax deduction for contributions – and the interest expense on money borrowed to invest in a TFSA isn't tax-deductible – the TFSA is extremely flexible and can be used to help meet both short- and long-term investment goals.

Who's Eligible to Open a TFSA?

Any individual (other than a trust) who's resident in Canada and who's age of majority is eligible to establish a TFSA.

You should be able to open a TFSA at most financial institutions, such as mutual fund companies, Canadian banks and trust companies, life insurance companies, and credit unions (i.e. typically the same financial institutions that are currently eligible to offer a Registered Retirement Savings Plan (RRSP)). A social insurance number is required to open a TFSA.

Making Contributions and Contribution Room

Each year you can contribute an amount up to your contribution room for the year. Your contribution room would be made up of three amounts:

1. Each year you would be allocated and allowed to contribute at least $5,000 (this annual amount will be indexed to inflation and increased to the nearest $500),
2. Any withdrawals made in the previous year would be added to the contribution room for the year, and
3. Any unused contribution room from the previous year would be added to the contribution room for the current year.

Example 1 (assumes no indexing to the annual $5,000 contribution amount):

In 2009, you'll 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 then would be $5,000 (for 2010) plus $3,000 (carried forward from 2009), or $8,000 in total.

If you don't contribute in 2010, but rather decide to withdraw $1,000, your contribution room for 2011 would be $5,000 (for 2011), plus $8,000 (carried

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forward from 2010), plus the $1,000 withdrawn (in 2010), or $14,000 in total.

Example 2 (assumes indexing at 2% inflation to the $5,000 annual contribution amount).

The annual TFSA contribution room amount won't increase until 2012 as follows:

- 2009 – $5,000
- 2010 – $5,100 ($5,000 + $100 (2% X $5,000))
- 2011 – $5,202 ($5,100 + $102 (2% X $5,100)), and
- 2012 – $5,500 ($5,202 + $104 (2% X $5,202)) = $5,306, which would be rounded up to $5,500 the nearest $500 increase).

If you become a non-resident of Canada, you'll be allowed to maintain your TFSA, and won't be taxed on any earnings in the TFSA; nor on withdrawals. However, you're not permitted to contribute any more money, and contribution room won't accrue any year in which you're a non-resident. When a non-resident returns to Canada, that individual can re-contribute any withdrawals made while a non-resident. Unused contribution room can be carried forward indefinitely.

If you contribute more than your contribution room, the excess contributions will be subject to a penalty tax of 1% per month, for each month the excess remains in the TFSA. This tax may be waived if the Canada Revenue Agency (CRA) is satisfied that the excess arose because of a reasonable error, and you arrange without delay for the excess to be withdrawn.

Contributions have no impact upon income-tested benefits since the contributions are not deductible and are made with after-tax money.

The CRA will determine the TFSA contribution room for a given year (based upon information provided by issuers) for each eligible individual who files a personal income tax return.

Individuals who haven't filed personal tax returns for prior years (for example, because there was no tax payable) would be permitted to establish their entitlement to contribution room by filing a personal tax return for those years, or by other means acceptable to the CRA.

Making Withdrawals

You're able to withdraw funds at any time for any reason from your TFSA, and the withdrawal amount isn't subject to income tax. The amount withdrawn from a TFSA can be re-contributed at a later date.

Withdrawals from a TFSA are not taken into account in determining eligibility for income-tested benefits or credits delivered through the income tax system (e.g. the Canada Child Tax Benefit, the Working Income Tax Benefit, the Goods and Services tax credit, and the age credit).

Furthermore, withdrawal amounts from a TFSA won't reduce other benefits that are based on the individual's income level, such as Old Age Security (OAS) benefits, the Guaranteed Income Supplement (GIS) payments, or Employment Insurance (EI) benefits.

Other TFSA Features

TFSA Transfers on Death

A TFSA plan holder can name his or her spouse or common-law partner as the successor holder of his or her TFSA. This means that, upon the death of the plan holder, the successor holder will become the new plan holder, and the TFSA can maintain its tax exempt status.

A trusteed TFSA (i.e. with a mutual fund company) that ceases to be a TFSA because of the death of the holder is deemed for certain provisions of Canada's *Income Tax Act* to continue to be a TFSA until the end of the year following the year in which the holder dies (the 'exempt period'), or when the trust ceases to exist, if earlier. The main effect of this rule is the trust continues to maintain its tax-exempt status during this exempt period. This rule puts the treatment of a TFSA on the same footing as a RRSP when the holder of a RRSP dies.

Payments from a TFSA to a beneficiary of the TFSA during this exempt period are required to be included in the beneficiary's income to the extent the payment represents the distribution of income earned on, or an appreciation in the value of, the TFSA's property during the exempt period. This payment will be reported on a T4A as "other income".

If a TFSA still exists after the exempt period, the TFSA will be taxable from that time forward, and will be treated as having disposed of, and reacquired, its property for its fair market value (FMV) at that time. The issuer (i.e. plan sponsor) of a TFSA will be required to file a T3 Trust Income Tax and Information Return for every year beyond the exempt period that the estate of the deceased holder of the TFSA remains unsettled.

Where a TFSA ceases to be a TFSA because of the death of the holder, the survivor holder (spouse or common law partner) may contribute an amount – called an 'exempt contribution' – (i.e. the deceased holder's unused TFSA contribution room) to his or her own TFSA without affecting the survivor holder's own TFSA contribution room.

Non-Residents and TFSAs

Non-residents also are not taxed on any earnings in or withdrawals from their TFSA. However, any payments made by a TFSA to a non-resident beneficiary from a deceased holder's TFSA during the exempt period (i.e. up to the end of the year following the year in which the holder dies or a TFSA otherwise ceases to exist) will be included in the non-resident beneficiary's income to the extent the payment from the TFSA represents the distribution of income earned on, or appreciation in the value of, the trust's property during the exempt period (i.e. after death income or growth of the TFSA). Canadian withholding tax will be applied by the Canadian issuer of the TFSA (under Canada's tax rules) on such payments to a non-resident beneficiary of a TFSA.

Any contributions made to a TFSA while an individual holder is a non-resident are subject to a special tax of 1% per month (of the contribution amount) until either:

- the non-resident individual withdraws and designates the withdrawal as a withdrawal of the non-resident contribution, or
- if earlier, the non-resident becomes a resident of Canada.

In addition, since no TFSA contribution room will accrue for any year throughout which a holder is a non-resident of Canada, this individual still will be subject to a 1% penalty tax per month on this excess contribution to a TFSA, after becoming a resident of Canada.

Non-residents may make withdrawals from their TFSAs. Any withdrawals made during the period that the holder is a non-resident will be added back to the holder's unused TFSA contribution room in the following year, but will only be available when the holder subsequently resumes residency status in Canada.

Types of Investments by a TFSA

Generally speaking, a TFSA will be permitted to hold the same type of investments as a RRSP. This would include mutual funds, segregated funds, publicly traded securities, GICs, bonds, and certain shares of small business corporations.

Individuals will be allowed to make in-kind contributions with property to their TFSA, provided the property is a qualified investment. As is the case with RRSPs, the individual will be considered to have disposed of the property for its Fair Market Value (FMV) at the time of the contribution. If the property's FMV exceeds its cost, the individual will realize and have to report the resulting capital gain on his or her income tax return. However, if the property's FMV is less than its cost, the resulting capital loss cannot be claimed, but rather will be lost and denied forever. In either case, the amount of the contribution to the TFSA will be equal to the FMV of the property.

Avoiding the superficial loss rules

Here are some ideas:

- Sell mutual fund trust units and repurchase the same investment exposure within a mutual fund corporation (or vice versa). Since the features and rights attached to the mutual fund units are different from those of the mutual fund corporation shares, they're not considered to be identical properties and your loss won't be denied.
- Sell your loss investment, park your money in a money market fund for 30 days, and then buy back the same investment you sold. Keep in mind, however, that you're taking on the risk that the investment will rebound in the 30 days you're out of the market.
- Buy a similar – but not the same – investment back again. So, if you've sold a U.S. equity fund, you can find another fund with similar exposure.
- Sell, or gift, your loss investment to a child.

In addition to the loss being lost forever if a loss security is contributed in kind, taxpayers have to ensure that they don't trigger the superficial loss rules if a TFSA acquires the same loss property in the prohibited timeframe.

Non-qualified or prohibited investments

If at any time in a taxation year a TFSA holds non-qualified or prohibited investments, the TFSA will be taxable on any income earned or capital gains realized from the non-qualified or prohibited investments, and the issuer of the TFSA will be required to file a T3 Trust Income Tax and Information Return. In addition, the holder of the TFSA will be liable for a 50% penalty tax (based upon the FMV of the non-qualified or prohibited property) at the time the non-qualified or prohibited property is acquired by the TFSA.

However, the holder of a TFSA may be entitled to a refund of this penalty tax if the non-qualified or prohibited property is disposed of by the TFSA before the end of the calendar year following the year in which the penalty tax arose. On the other hand, a holder of a TFSA won't be entitled to a refund if it's reasonable to expect that the holder knew, or ought to have known at the time the property was acquired by the TFSA, that the property was or would become a non-qualified or prohibited investment.

Loans and Security

The good news for investors is a TFSA may be used as security for a loan.

TFSA Fees

The payment of fees by the holder of a TFSA won't constitute a contribution to the TFSA, or be deductible by the holder. The payment of fees by a TFSA itself won't be treated as a withdrawal by the holder.

Contributions on behalf of your spouse or common law partner

If you provide funds to your spouse or common-law partner to invest in a TFSA, the good news is that income earned in that TFSA won't be attributed back to you.

For example, this means the attribution rules in Canada's *Income Tax Act* won't apply to income earned in, or withdrawals from a TFSA, where you provide funds to your spouse or common-law partner so that he or she can take advantage of his or her TFSA contribution room.

Marriage Breakdown

If there's a breakdown of a marriage or common-law relationship, an amount can be transferred directly from one spouse or common-law partner's TFSA to the other spouse or common law partner's TFSA. The amount of this transfer wouldn't affect either person's contribution room. For example, the recipient spouse or common law partner's TFSA contribution room won't reduce – nor will any contribution room be reacquired – by the transferring spouse or common law partner.

Conclusion

The introduction of the TFSA (also referred to as a tax paid savings plan because contributions are made from after-tax earnings) long has been requested by the investment funds industry. Consequently, the new TFSA is great news for Canadians to help accumulate future savings and tax efficient income with the assistance of their financial advisors. Speak to your financial advisor for more information about the new TFSA.

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