TFSAs - A Less Taxing Way to Invest

Rewind to 2009 when Barrack Obama made history being inaugurated as the first African American President of the United States. It was also the birth of the Tax-Free Savings Account (TFSA) in Canada.

In the early years, investors were keen to see how much interest they could make on this new 'savings' account. We quickly realized perhaps a better name would have been a *Tax-Free Investment Account* to help promote that investors were not limited to just savings and can hold many different investment options similar to Retirement Savings Plans (RSPs).

How they work:

A Canadian resident can open a TFSA at age of majority, which is 19 years old in BC. Available room starts accumulating at age 18 and, similar to RSPs, unused contribution room is available for future use. The 2023 annual limit is now $6,500 and the lifetime limit is $88,000.

Monies in a TFSA can be withdrawn anytime and any gains (interest, dividends or capital appreciation) are completely tax free. Investors can also replace any withdrawals the following calendar year without impacting available limits.

You can look up your individual TFSA room online with Revenue Canada or with help from your tax professional. We recommend that individuals only open one TFSA account for ease of tracking deposits and withdrawals. The penalties for over contributing are strict and levied at 1% per month by Revenue Canada.

Pro Tip#1: If maxed out, you can give money to your spouse to invest in their TFSA without any tax implications and utilize their available room.

For estate planning purposes, Tax Free Accounts have the ability to name a beneficiary so that proceeds can flow tax-free and avoid probate.

Pro tip #2: If electing your spouse as beneficiary, we recommend having them named as *successor annuitant* as this allows the deceased's TFSA to be added to survivor's TFSA without affecting the spouse's contribution room.

The Power of Tax-Free Savings

Example 1:

Bob starts investing in a TFSA with $6,500 a year and earns an average return of 5%. After 10 years, his TFSA would grow to $85,844. In 20 years, he would amass $225,675 that he never pays tax on… ever.

Example 2:

Sara receives an inheritance and places $88,000 into a new TFSA, maxing it out. She never adds another dollar and averages 5% a year return. After 10 years, her TFSA would be worth $143,343. In 20 years, her TFSA would surpass $233,490 or grow by 165% tax free!

TFSA or RSP?

A common question we are asked is, "Is it better to save in an RSP or TFSA?" The answer will depend on individual circumstance and income. An RSP contribution will get you a tax deduction, investments grow tax deferred and taxed upon withdrawal. This is typically in retirement when individuals should be in a lower tax bracket than their working years.

A TFSA is funded with after-tax dollars and receives no tax deduction, but all future growth is tax-free and withdrawals are not taxed at all.

If you are currently in a lower tax bracket and anticipate remaining in low bracket in retirement, then contributing to your TFSA rather than your RSP could make more sense.

Conversely, if you are in a higher tax bracket and anticipate being in a lower bracket in retirement, then an RSP contribution could be better served.

Another instance a TFSA can be beneficial is if you receive a windfall (inheritance, proceeds from house sale, gift, etc.), as investing in your TFSA keeps all future growth tax free.

As always, we encourage working with a financial professional to discuss what works best for your specific circumstance.

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