Life Choices... a newsletter from Latimer Financial Services

Retirement and Tax Planning   Education Funding   Portfolio Review
Long Term Care   Life Insurance   Critical Illness   and Disability Insurance

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Tax-Free Savings Accounts (TFSAs)

NEW ! FREE ! DIFFERENT ! OPPORTUNITY !

How often are these words used in our everyday lives? How often are they truly justified? The Tax-Free Savings Account (TFSA), available January 1st is all of these things, offering a revolutionary new way for Canadians to save.

For many people, announcements from Ottawa seem to go largely unnoticed. This has certainly been an exception. Everyone seems to be aware of TFSAs, while few are clear on the details.

We've heard many of you ask things like, "What do they pay?" or "What are their numbers like?" Both honest questions. However, the TFSA is not the investment, rather it is merely the wrapper on the investment, much like an RRSP is an investment which has a "registered" wrapper on it. Essentially anything that is eligible for investment as an RRSP is eligible for the TFSA.

The eligible amount for deposit will start at $ 5,000 per person, per year. The Canada Revenue Agency tells us that this amount will be indexed with inflation and rounded to the nearest $ 500.

The biggest advantage with the TFSA is that all investment income, interest and growth is tax free. Tax free now and tax free later. You don't pay any tax on the growth as you earn it. Nor do you pay any tax on the growth as you receive it. (However, you don't receive a tax deduction for what you deposit as you do with an RRSP so the "invested capital" that you eventually redeem is your own after tax dollars coming back to you).

Other advantages include:

- As long as you are 18 years old or older and file a tax return, you may contribute to a TFSA. Thus, two spouses may contribute a total of $ 10,000 in 2009.
- Everyone has the same opportunity, regardless of income. That is, what you can contribute does not depend on how much you make.
- Withdrawals from a TFSA do not affect means tested government benefits like the Old Age Security or the OAS Supplement.
- "Unused" deposit room may be carried forward, indefinitely.
- In the event of your death, you may pass your TFSA on, again tax free, to your "successor – holder" spouse.
- What is withdrawn from a TFSA may be replaced in a subsequent year, on top of your current contribution room.

TFSAs for every stage of life

Often, when people evaluate investment options, they look for the "silver bullet method". The one best way to navigate their choice. However, as with most things in life, there is never a one-size-fits-all solution. A good example of this is the old question, "Should I pay down my mortgage or deposit to my RRSP?" The answer to that question depends on who is asking. Similarly, who can best utilize the TFSA depends on your circumstances.

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TFSAs as a supplement to Registered Education Savings Plans:

Let's say you have $ 5,000 to invest in your child's education this year. You could put all of it into an RESP but you'll only receive the Canada Education Savings Grant (CESG) on the first $ 2,500. Why not put the other $ 2,500 into a TFSA (in the name of the parent, if the child is under the age of 18). You can personally earmark that money for education purposes but you'll have more flexibility if the child does not go to school or does not need everything saved for education purposes.

What if the child is older, say 18 or 19 and working while attending school? You can make tax deferred deposits to an RESP beyond age 17, but they won't be eligible for the grant. Why not use a TFSA? This time, because the child is an adult, the deposit can be made in his or her own name.

TFSAs as an alternative to RRSPs when saving for a home:

The Home Buyer's Plan is not our favorite way to see clients save for the purchase of a home. They are required to pay their RRSPs back over a 15-year period and in reality are counting on their house appreciating more than their portfolio. The younger set may not appreciate this but increases in the housing market, like what we saw during the housing boom of the last five years, are not a given. However, many believe it has now ended.

Using a TFSA to save for the eventual purchase of a home means you will give up the immediate tax deduction you would have had with an RRSP. However, often times those contemplating the Home Buyer's Plan strategy are not in their peak earnings years anyway. In addition, withdrawals from a TFSA don't have to be paid back. (While you have the right to replace the money, you are under no obligation to do so).

TFSAs as an alternative to RRSPs as a way to save for continuing education:

Similarly, as an alternative to the Life Long Learning Plan, you would be under no obligation to repay withdrawals from a TFSA to fund education later on in life. (Withdrawals from RRSPs for the Life Long Learning Plan must be repaid over a maximum of 10 years).

TFSAs for use in retirement:

Of all the potential uses for a TFSA, perhaps the most powerful and effective is as a retirement income supplement. After all, the whole attraction to the TFSA is the tax-free nature of the investment growth. This means we have to let the soup simmer long enough for it to be interesting, before we'll see the maximum benefit.

The opportunity this represents is truly significant. How significant? Let's look at some examples.

How much could we accumulate, say by age 65, starting at various ages, if the government just left us alone? We assume our TFSA earns a tax free 5 % and we experience 2 % inflation throughout. (This is also a nifty example of the magic of compound interest).

- A 50 year old starting now would accumulate $ 137,188
- A 40 year old starting now would accumulate $ 319,335
- A 30 year old starting now would accumulate $ 636,444, and
- The well organized 18 year old "keener" everyone loves to hate would accumulate a whopping $ 1,326,148.

Now, if you are 50 years old (or older) don't despair that the government didn't invent the TFSA 30 years ago. Keep in mind that while you have less time to take advantage of this opportunity, your tax-free savings won't be exposed to the ravages of inflation for as long either. (Don't tell the 18 year old that even at only 2 % inflation, his $ 1.3 Million will only be worth a little more than $ 500,000 by the time he stops saving).

In addition, keep in mind that if you're married, this is an opportunity both spouses can take advantage of. If we look at our 50 year old again, that means between both spouses they could accumulate a tax free $ 274,376 by age 65 – a tidy sum indeed! If they continued to earn 5 % throughout retirement and lived to be 90 years old, this would be enough to generate $ 1,603 per month – in tax-free income.

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That's almost $ 20,000 a year that wouldn't impede in any way your ability to collect the Old Age Security benefit. If we force ourselves to look down the road a bit, this is also income that won't affect how much you're charged for certain long term care facilities, either.

We continue to believe in RRSPs as the best way to save for retirement. However, they are not a one-size-fits-all solution. We've counseled clients for years that by the time you retire, you shouldn't have all your retirement assets under the "registered" umbrella. If all your savings consists of a company pension or group retirement savings plan and your own personal RRSPs, you'll want to consider saving some non-registered funds for larger purchases that will be necessary.

Refrigerators, roofs and automobiles all need major repair or replacement from time to time. It has always been more tax efficient to draw on non registered funds for these larger purchases. However, until now, even with non-registered funds, redemptions have often meant a deemed disposition for tax purposes and possible tax on gains. With the creation of the TFSA, you have an opportunity draw on these funds without regard for even a deemed disposition.

After hearing all this positive news, one of the most frequent questions we get sounds something like, "This sounds too good to be true! How can the government do this?" Well fear not, we have not lost our heads!

If we look to the utilization of RRSPs as an example, the results are surprising:

- Only one-quarter of those eligible have ever made an RRSP contribution.
- Canadians have managed to save only 7 % of what was possible to save in RRSPs.
- The median contribution to RRSPs in 2006 was only $ 2,730.

While you digest the above information, consider that we are in an era where there is a great deal of pressure on company pension plans. For years now, fewer and fewer employers have been offering defined benefit pension plans. This should have led to an increase in RRSP utilization, but it has not.

If we transfer this experience to the Tax-Free Savings Account, one could easily predict that a relatively small percentage of the population will take advantage of them. In addition, of those who do, how many will be able to maximize their contribution?

We submit that the most beneficial use of the TFSA is for long-term retirement savings where the savings can grow on a tax-free basis for the longest period. Now ask yourself, of those who decide to utilize the TFSA, how many will avail themselves of the feature that allows them to withdraw contributions and growth well before retirement, with the good intention of replacing the money down the road? How successful do you think the average person will be at replacing these funds as intended? How many people do you know with thousands, even tens of thousands of dollars in unused RRSP room? How easy is it to "find' the deposit later?

Lastly, ask yourself where the average investor will find the money to deposit into a TFSA? Is it not likely many will find the money in their RRSP budget? If they do, the government is relieved of the burden of having to refund the tax on that deposit. The TFSA is not "too good to be true." We submit that in the final analysis, the TFSA won't end up costing the government very much, if anything.

However, we sincerely hope our clients will see the TFSA for the real opportunity it is and utilize the tool to maximum advantage. Make the tax department sorry, as far as you're concerned, that they offered you such a powerful tool. Be one of the few – and not the many!

Let us show you how!

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