Retirement: Use of the TFSA Account

How Do I Use the TFSA Account?

By: Joe the Investor

The TFSA or Tax Free Savings Account is designed for people to obtain tax free income and withdraw funds if they want to. The intention behind this vehicle is to get people to save money – which is why it is called a “savings account”. The incentive to save comes in the form of tax relief on the income generated, and the flexibility of withdrawal which the RRSP and RESP do not have. If you are already a disciplined saver, you may not need this type of account, but you may want to use it if the tax savings are worthwhile in your current financial situation.

One key word to remember is “income”. The money deposited into the account is not tax free, and will not generate a refund like the RRSP contribution will. Only after you made some income will you see the effect of not paying taxes on this money earned. The flip side of this is that if you lose money that you invested in the TFSA account, you cannot claim the losses.

Another thing that can arise among TFSA account holders is the redeposit of money back into the account after withdrawal. If you take out money from the account, you would have to wait until the following calendar year before you can replenish the amount of money you withdrew. If you do it beforehand, you may trigger taxes owing to the government, which you would have to pay by June 30th of the following year in question. See the CRA web site for details - Source 1) below. (1) (3)

What about fees? Due to the small amount of money that is eligible for a TFSA account, you have to watch the effect of fees. There are three types of accounts available: the savings account, the mutual fund account and the self-directed brokerage account. These accounts will have differing fees (4) (5) (6). Every fee that you pay will reduce the income generated in the account, and because the maximum amounts are relatively small (up to $20,000 in 2012), the fees can cancel out the gains made on the income generated.

If a TFSA is being considered simply for saving money, and investing in cash or short term bonds, this account may not be worthwhile. It would likely be just as lucrative for you to have an ordinary high interest savings account, and treat that as a “savings reservoir”. You can withdraw money whenever you want to, and **as often as you want to**. There is no tax advantage in doing this, but the government does not make it mandatory to issue T5 tax receipts if income is under $50. (7) If you have a $10,000 TFSA account and you earn 1% for a year, this would amount to $100. If you have a $50 fee on the account, you would have $100 - $50 = $50 worth of income. In this scenario, you may not even have to declare the $50 as income since a receipt may not be issued. (7) The time and effort to register the account and keep track of the contributions may not justify having the TFSA account. If you make a net income of $200 instead of the $50 as per the above, and if your tax rate is 30%, the tax savings is: $150 multiplied by 30% = $45 per year. Of course, as the dollar amounts invested go up and the returns go up, the tax savings will be more worthwhile.

If you are going to open as TFSA account, you should invest the money in something that generates good return, at least 3% or more per year on a $10,000 account size, while minimizing the losses you may receive. This way, the tax benefit is maximized, and the money is available relatively quickly if needed. You would need to be able to generate this return consistently, so if your investing record is poor, it may not be tax efficient. In terms of comparing to other options, paying down debt or using your RRSP instead of using the TFSA may be more useful in terms of a long term overall plan. If you have uneven cash flow and want to save money for short term use, the TFSA would be helpful.

The TFSA Compared to the RRSP

How does the TFSA differ from the RRSP? There are a number of differences. The RRSP is intended for people to save for their retirement, so it is assumed to be money you don't intend to withdraw for a long time. The TFSA is designed more for saving, and possible frequent withdrawals. Take note that many institutions charge fees for withdrawals (4) (5) (6), and this should be accounted for if your account balance is small, your rate or return generated within the account is low, and your withdrawals are frequent.

The RRSP will give you a **tax deferral** on **all of the money** you put into the account. Take note that tax deferral does not mean you do not pay taxes on this money – you pay taxes **later** on the money deposited and all of the money it generates upon withdrawal. Once money is withdrawn, you cannot redeposit the money back into the RRSP account unless you have new contribution room that you would have generated with more taxable income. The taxes you pay depends on your marginal (or highest) tax rate in the year that you deposit the money. The taxes paid on withdrawal will depend on the marginal (or highest) tax rate in the year you make the withdrawal. With the TFSA, the money deposited is not affected by taxes. Only the income generated is tax exempt, and you can replenish the amount as often as you like (within CRA tax rules).

The RRSP will depend on your income situation, whereas the TFSA does not. The maximum TFSA amounts are determined by the government, and anyone can put the stated amounts into an account regardless of their income situation. The maximum has been increasing each year by $5000 since the beginning of the program, and is currently $20,000 for all of your TFSA accounts. Like the RRSP, the unused portion of this amount can be carried forward and used in later years, or not used at all – the choice is yours. (2) (3)

The Tax Free Savings Account is a useful tool to be aware of, but it is not for everyone. Knowing the best time to use this account and its limitations would go a long way to understanding what is best for your situation.

Contact me, Joe Barbieri by email at joetheinvestor.today@gmail.com, or by telephone at 647-286-8020 for an independent consultation on what your options are. **Note: This site is intended for people who want to learn about the world of investments and how to research for themselves. If you would like to buy or sell investment products, or specific advice on investment products, tax or legal issues, please consult your investment advisor, accountant or legal counsel.**

Sources:

1) http://www.tfsa.gc.ca/
2) http://www.theglobeandmail.com/globe-investor/personal-finance/ottawa-chastised-for-handling-of-tfsa-tax-rules/article2123150/
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