

# FineAnswers

## Answers to questions on Tax, Finance and Management

### Tax Free Savings Accounts — July 2009

By Joseph Tavana CA, CFP

## TFSA

### 1) What is a Tax Free Savings Account (TFSA) and what are its benefits?

A Tax Free Savings Account is an ARRANGEMENT which enables Canadian residents, over eighteen years of age, to accumulate their savings tax free. The contributions, unlike RRSP contributions, are not tax deductible. Funds in TFSA's can be used to earn interest, dividends or appreciate in value tax free and, unlike RRSP's, can be withdrawn tax free.

### 2) What is the legal nature of a TFSA?

TFSA's are trusts and are exempt from taxation [ITA 146.2\(6\)](#). But, they can become taxable if they hold prohibited/ unqualified investments or if the TFSA arrangement terminates. (*see 14 below*)

### 3) Who can contribute?

Unlike an RRSP, there is a minimum age to contribute to a TFSA and no maximum age. The minimum age for contribution is eighteen.

### 4) Who should contribute?

Anyone who has funds to invest.

### 5) How much can one contribute?

The maximum contribution is \$5,000 for 2009 and each subsequent year. The \$5,000 could increase by \$500 increments to adjust for inflation. Also added to each year's limit is the previous years' cumulative withdrawals minus cumulative contributions to date, including the current year. This arrangement will continue until the TFSA is terminated.

### 6) At what dates should I contribute to my TFSA?

The sooner in the year contributions are made, the longer the funds can accumulate tax free income and capital gains.

### 7) Can one overcontribute?

Unlike an RRSP, there is no maximum amount of over-contribution to a TFSA. Over-contributions will be subject to a tax of 1% per month levied on the highest balance outstanding during that month. The penalty continues until the excess contribution is withdrawn. [ITA 207.02](#)

### 8) Can one withdraw funds from TFSA's tax free?

Yes, withdrawals are tax free. Any amount withdrawn actually adds to the contribution limit. In other words, if the investments in the TFSA appreciate and are withdrawn, this appreciated amount is added to the TFSA contribution limit for the following year. (*see 5 above*)

### 9) Can one withdraw from TFSA and contribute the same amount in the same year.

No. As explained in (8), above, withdrawals create contribution room only for the FOLLOWING calendar year, unless you have contribution room for the current year.

### 10) Do I pay Canadian tax on my TFSA income if I become a non-resident of Canada?

No, unless you contribute to your TFSA while you are a non-resident of Canada, in which case your contributions would be taxed as over-contribution at the rate of 1% per month levied on the highest balance outstanding, regardless whether you have contribution room or not. The tax continues until the contribution is withdrawn or the holder resumes Canadian residency.

**ITA 207.03**

TIP; fully contribute to your TFSA before acquiring non-residency status. There is no departure tax on TFSA assets should you emigrate from Canada.

**11) When should one not contribute to a TFSA?**

You should not contribute to a TFSA while you are a non-resident of Canada.

**12) What types of investments can I hold in my TFSA?**

The Income Tax Act requires that the investments: (i) not be *prohibited*; and (ii) be *qualified*, as defined in [ITA 207.01\(1\)](#).

Some important types of non-prohibited and qualified investments include bank deposits, GIC's, Treasury Bills, Government of Canada Bonds, mutual funds, stocks quoted on stock exchanges recognized by Canada Revenue Agency, mortgages insured by Canada Mortgage Housing Corporation (CMHC) or by an approved mortgage insurer and shares of a Specified Small Business Corporation. ([ITA 207.01 Reg. 4900 \(1\), 5000 and 5001](#)).

**13) Is there a penalty for holding prohibited or unqualified investments in the TFSA?**

There is a one time tax of 50% on of the value of the property that is prohibited or is not qualified or later becomes prohibited or not qualified [ITA 207.04\(2\)](#). However, the tax would be refunded should the offending property be disposed of by the end of the calendar year after the year in which the tax was levied and the holder did not know, or it was reasonable to assume that he or she could not have known, that the property was prohibited or not qualified.

**14) Would there be a tax on the income earned in the TFSA from the prohibited or the unqualified investments?**

The tax would be at the top federal tax rate for an individual, multiplied by 1.5, which amounts to 43.5%

**15) What kind of a corporation is a Specified Small Business Corporation?**

A Specified Small Business Corporation is a Canadian controlled corporation – public or private – in which substantially all of the assets (*i.e.*  $\geq 90\%$ ) are used in an active business or those assets are comprised of shares of a Specified Small Business Corporation. However, the holder of the TFSA or anyone related to the holder must NOT have a *significant interest* [Reg. 4901\(2\) and ITA207.01\(1\)](#) in the corporation, otherwise it will become a prohibited investment. A “significant interest” is defined to be beneficial ownership of 10% or more of any class of shares of the corporation. [ITA 248\(1\)](#)

**16) Can I contribute shares of my own private corporation?**

No, unless, among other things, neither the holder of the TFSA, nor anyone related to the holder, has a “significant interest” in the corporation. (*see 15 above*).

**17) Can I borrow from the TFSA?**

No. If you do, in effect the TFSA is investing in prohibited investments. However, your TFSA can give you a mortgage as long as it is administered by an approved lender and insured by CMHC or an approved mortgage insurer. [Reg. 4900\(1\)\(j.1\)](#)

**18) Can a TFSA invest in options?**

Yes, it can invest in call options of qualified securities. Also, it can sell covered call options. In other words if the TFSA owns the stock it can sell the call option on that stock. [ITA Reg. 4900\(1\)\(e\)](#).

**19) Can I have a self directed TFSA and what is it?**

Yes. A self directed plan is one in which you have control over your investments and you can buy and sell as you choose.

## 20) Can I contribute assets other than cash?

Yes, if your plan is self directed! You can transfer qualified stocks, bonds, etc., to your TFSA. The transfer should be at market value. The transfer is considered to be a sale of the bonds, stocks, etc. If a capital gain results from the sale, then it should be included in your income. However, a capital loss is not allowed (see our Newsletter on Superficial Losses). Instead of transferring a property to your TFSA that will give you a non-deductible capital loss, you should sell that property, realize the loss, contribute the funds to your TFSA and have your TFSA buy the same property. BUT, the purchase must be made after the lapse of thirty days from the date of sale.

## 21) Can I exchange qualified assets outside of the TFSA with the ones inside?

Yes, if your TFSA is self directed and the outside assets are qualified you can. You may, however, trigger a capital gain or a non-deductible capital loss by doing this.

## 22) Should I borrow and invest in a TFSA?

Interest paid on borrowed money invested in a TFSA is not deductible. If you do not withdraw funds from your TFSA for a number of years it is usually to your advantage to borrow and contribute. You should also take into consideration your level of taxable income, income you receive on your TFSA funds and the interest you pay to the lender.

## 23) Are administrative fees and management fees paid for the TFSA deductible? Is it better to pay such fees from funds outside the TFSA?

No they are not deductible [ITA 18\(1\) \(u\)](#). It is better to pay those fees from funds outside the TFSA. The reason is that funds left in the TFSA accumulate tax free, while interest earned and gains realized outside the shelter of TFSA, are taxed.

## 24) Are funds in the TFSA protected from creditors in the event of bankruptcy?

No.

## 25) Should I pay-down my mortgage or contribute to my TFSA?

The answer to your question depends mainly on your mortgage interest rate and the rate of return of your investments inside the TFSA. All things being equal it makes no difference.

## 26) Can I rent TFSA room from someone who does not need it?

If what you mean is to lend money to someone with a TFSA account and ask him or her to return the money to you plus interest earned in the TFSA, then the entire amount of the interest earned, or the *advantage*, will have to be paid as tax. (*see 27 below*)

## 27) Will it be possible to have an arrangement to enrich the return of investments in the TFSA while taking the risk or compensating for it outside the TFSA?

No. Once determined that this enrichment, which the Income Tax Act refers to as *advantage* [ITA 207\(1\)](#), was given to the TFSA, then the entire amount of the *advantage* is taxed at 100%. [ITA 207.05\(1\), \(2\) and \(3\)](#)

## 28) Who pays the tax on this (see 27 above) advantage?

Usually the TFSA, unless the issuer (issuer is normally the financial institution arranging the TFSA) provided the advantage or another non-arms length person (normally an entity related to the holder of the TFSA). In such cases they and not the TFSA will pay the entire amount of the advantage as tax.

## 29) If I have multiple TFSA accounts can I consolidate my accounts into one or more accounts?

Yes. [ITA 207.01\(1\)](#) “*qualifying transfer*”

### 30) Can I name anyone as the beneficiary to my TFSA and what are the consequences in the event of my death?

No. You cannot name anyone other than your spouse or common law partner as your beneficiary. Your TFSA will merge with your beneficiary’s TFSA upon your death.

The Ontario government proposes to change the *Succession Law Reform Act* (SLRA) to allow for beneficiary designation of Tax-Free Savings Accounts (TFSAs). Designated beneficiaries would be able to receive TFSAs outside of a will in the same way that beneficiaries can receive proceeds of RRSPs. The TFSA could also pass to the designated beneficiary without being subject to Estate Administration Tax, simplifying estate matters and reducing costs.

### 31) What if one has not named one’s spouse as the beneficiary? What are the consequences?

The spouse or common law partner receives the deceased spouse’s TFSA investments tax free and can make a contribution to his or her TFSA for the entire amount. This contribution has to be made within two years of spouse’s death in the prescribed manner. [ITA 207.01\(2\)](#).

### 32) A TFSA is a non-taxable trust. Will it be subject to tax when the TFSA holder dies?

No, the trust will not be taxable when the holder dies. If no beneficiary is named to the TFSA, the survivor (the spouse) of the TFSA holder will be subject to tax on any income earned after the holder’s death, unless the survivor makes an exempt transfer to his or her TFSA using the prescribed form [RC240e](#). If the deceased holder does not have a spouse the estate receives the TFSA investments at an adjusted cost base equal to their fair market value at the time of the holder’s death. The estate will be taxable from that date on.

### 33) Can I consolidate my TFSA with my spouse and have one TFSA?

No. However, you can make a transfer to your spouse if you have separated. [ITA 207.01\(1\)](#) “*qualifying transfer*”

### 34) Some tax planning ideas?

- a) Name your spouse as the beneficiary of your TFSA. This will avoid the hassle of having to make an exempt contribution (see above).
- b) Keep income generating investments in your TFSA while keeping capital assets exposed to capital losses outside the TFSA.
- c) If you have dividend paying US stocks in your TFSA, remember that you cannot claim the US withholding tax as a credit on your personal tax return. You would normally be allowed to do that if your stocks were held outside your TFSA. In the case of RRSP’s  
The US/Canada tax treaty [[Article XXI \(2\)](#)] provides that one can request the institution paying the dividend to your RRSP, not to deduct it. But, since a TFSA is not a retirement or pension arrangement, it seems that this approach would not be available for a TFSA.
- d) When you are nervous about a stock in your TFSA that has appreciated and you fear that it may fall, but you are not sure, you can sell it, withdraw the proceeds and buy it outside the TFSA. Should your dire predictions start to materialize and the stock, which now you own outside the TFSA, starts on a downtrend you can then sell it. This procedure has the advantage of you claiming a capital loss and at same time preserving your TFSA room. Make sure you sell all in one go and also buy them back in one transaction and after your final sale do not buy them back over the next 30 days either in your TFSA or outside it. This is to avoid some potential pitfalls of the superficial loss provisions of the income tax act which denies your capital loss.

*Note: This newsletter is for general information only and cannot replace professional advice. The reader is invited to contact the writer to discuss the contents of the newsletter. Readers are advised to seek professional advice before acting on the material in this newsletter*