TFSA 101

A Primer on Tax Free Savings Accounts

Guest column
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[This article is heavily edited for length, the full article is available on our website www.taxpayer.com/pdf/TFSA.pdf]

The Tax Free Savings Account (TFSA) is finally here. The new tax shelter that allows investments to earn income tax-free for life went into place January 1st.

How the TFSA works

The TFSA is a simple concept, similar to the RRSP model, but with some extra and attractive provisions.

First, the TFSA is available to everyone over the age of 18. By contrast, RRSPs are only available to those who earn income from employment, self-employment, net rentals and royalties for those under 71.

Like the RRSP, a TFSA accepts annual contributions. But, its contribution limit is cumulative over a lifetime.

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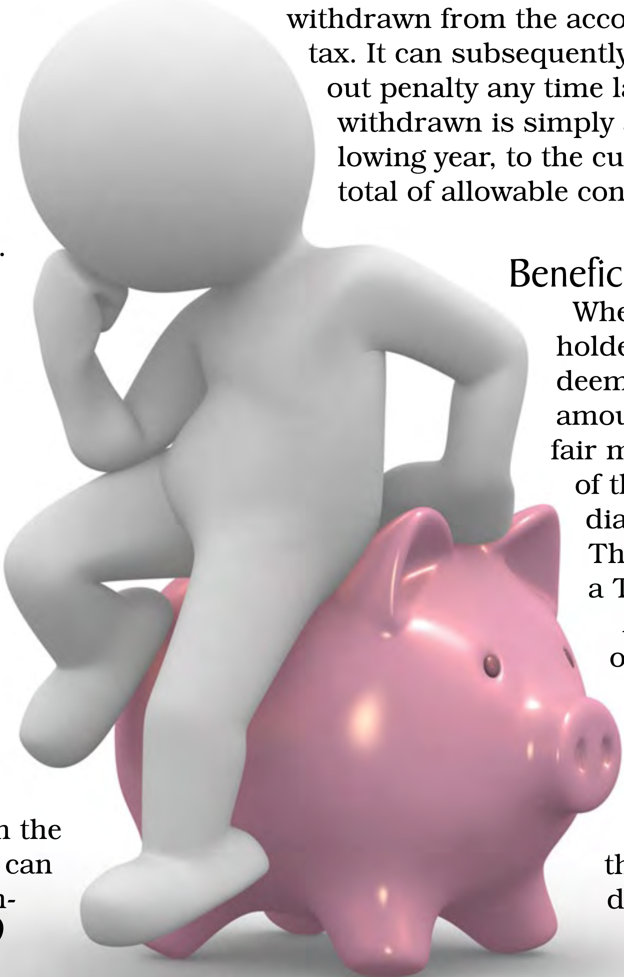

So, if a contribution isn't made in a year, the missed amount is simply added to the allowable contribution for the next or any following year. However, because a TFSA isn't based on "earned income" as is the RRSP, the annual limit is the same for everyone. This limit is $5,000 in 2009 but will be adjusted for the rate of inflation in all future years.

And, similar to an RRSP, income accumulates tax-free while in the account. But, differently, TFSA income and/or capital can be withdrawn from the account without paying tax. It can subsequently be replaced without penalty any time later. The amount withdrawn is simply added, in the following year, to the cumulative lifetime total of allowable contributions.

Beneficiaries

When a TFSA plan holder dies, he is deemed to receive an amount equal to the fair market value (FMV) of the account immediately before death. The plan is no longer a TFSA.

A TFSA can have one or more beneficiaries, as can an RRSP. Beneficiaries must include any earnings accrued after the plan holder's death in their income for the year they're received. However, beneficiaries don't pay tax on the payments received unless they exceed the FMV of the TFSA at the time of death.

There is one notable exception: If the deceased holder named his spouse or common-law partner as the sole beneficiary of the plan (either on the plan or in his will), the TFSA continues and the spouse or common-law partner becomes the successor holder under the plan and continues with it as if it were her own.

But if the plan holder named anyone else along with his spouse or common-law partner as beneficiaries of the TFSA, there is no successor holder. The spouse or common-law partner is then simply one of the beneficiaries.

TFSA and Benefits

Thanks to the TFSA, seniors and low income earners have less reason to be concerned about forfeiting social benefits because of money earned from their savings.

Neither income earned in, nor funds withdrawn from a TFSA affect eligibility any for federal income-tested benefits and credits. This list includes the recently-raised Working Income Tax Benefit, Employment Insurance, GST Tax Credit, Old Age Security, Guaranteed Income Supplement, age amount and the Canada Child Tax Benefit.

This said, the provinces march to their own drummers, and don't necessarily synchronize their benefits with Ottawa. It's wise to check with the province you live in and not presume anything.

Be warned: there are steep penalties for over contributing to a TFSA, so it's wise to keep track. Know also that you can have more than one TFSA account with different institutions or even the same one. For example, you might want one account to hold ready cash and another, as your accumulation increases, to accommodate longer-term investments.■

For more detail see the CRA website at http://www.cra-arc.gc.ca or contact your financial advisor.

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