

Federal Budget 2008 – Investors Benefit from Tax-Free Saving with TFSAs

Canadians received an added bonus in this year's Federal budget proposals – the chance to save an additional \$5,000 per year in a tax-exempt account. The introduction of the Tax-Free Savings Account (TFSA) in 2009 will give investors the opportunity to increase their retirement investing or other saving, without having to share their gains with the taxman.

Tax-free growth and withdrawals

A TFSA can be considered a 'tax pre-paid savings plan' as contributions are made from after-tax income; income and gains earned within the account and withdrawals are not subject to tax. Investments that qualify for TFSAs are generally the same as RRSPs and can include alternatives such as most stocks, bonds and mutual funds. If you don't invest up to your \$5,000 annual limit, any unused contribution room will be carried forward indefinitely.



How do TFSAs compare to RRSPs?

The assets of both TFSAs and RRSPs grow on a tax-free basis while held in your accounts. However, unlike RRSPs, you won't receive a tax deduction for your contribution; your contributions are made with after-tax income. In contrast with RRSPs, withdrawals from a TFSA are not taxed as you will have paid tax on the sources of your original contributions. TFSAs are one more tool investors can use in meeting their long-term savings goals. See the chart below for a comparison of TFSA and RRSP investments.

Comparison of TFSA and RRSP growth and taxation*

	TFSA	RRSP
Pre-tax income	\$1,000	\$1,000
Tax (40% rate)	\$ 400	–
Net contribution¹	\$ 600	\$1,000
Investment income (20 years at 5.5%)	\$1,151	\$1,918
Gross proceeds (Net contribution + investment income)	\$1,751	\$2,918
Tax (40% rate)	–	\$1,167
Net proceeds	\$1,751	\$1,751
Net annual after-tax rate of return² (%)	5.5%	5.5%

¹ Forgone consumption (saving) is \$600 in all cases. In the RRSP case, the person contributes \$1,000 but receives a \$400 reduction in tax, thereby sacrificing net consumption of \$600.

² Measured in relation to forgone consumption of \$600. Assumes annual nominal pre-tax rate of return is 5.5% invested for 20 years.

* Source: Federal Budget 2008.



Income splitting and estate planning benefits

Couples will be able to use TFSAs to their benefit as accounts will not be subject to the Income Tax Act's attribution rules surrounding the splitting of income or capital gains between spouses. TFSAs also offer the chance for you to enhance your estate planning. Assets can pass to surviving partners on a tax-exempt basis with the added incentive of not affecting their personal TFSA contribution limit.



No affect to government benefits

If you are concerned that your TFSA assets will affect your eligibility for government programs, you don't need to worry. Withdrawals from TFSAs will not be considered income and therefore will have no impact on Federal government benefits or credits such as Guaranteed Income Supplement (GIS), Old Age Security (OAS), the Canadian Child Tax Benefit or the GST Tax Credit.

LIFs and RESP changes

The budget also introduced proposed changes to Registered Education Savings Plans (RESPs) and to Federal Life Income Funds (LIFs), summarized below.

Extension of RESP time limits

Students received some relief from the budget proposals in the form of RESP time limit extensions. The contribution period and the timing surrounding the collapse of plans were both extended by a decade. Contributions may now be made to RESPs for 31 years after the plan's commencement and must be collapsed 35 years following the year of the account's opening.

Changes to Federal LIF Withdrawals

Providing LIF investors with greater access to their plan assets by loosening the definition of "locked" is also a feature of this year's budget. If the budget passes, LIF holders aged 55 and over with balances of \$22,450 or lower, will now be able to wind-up their plans or transfer assets to other tax-deferred investment options. LIF holders aged 55 and over will also be able to unlock up to half of their assets and transfer them to alternate tax-deferred investments that do not have maximum withdrawal limits. Finally, if a LIF investor of any age faces financial hardship, they will be able to unlock up to \$22,450 of their assets to assist them.

TFSA Highlights:

- \$5,000 maximum annual contribution limit.
- Contribution room may be carried forward indefinitely.
- Offers the opportunity of tax-free growth and withdrawals.
- Individuals age 18 and over can contribute.
- No deductions may be made to an investor's income, as contributions are made with after-tax assets.
- Money may be borrowed to contribute to a TFSA, but loan interest will not be tax deductible.
- Contributions in excess of TFSA limits will be subject to a penalty tax of 1% per month.
- Should investors separate or divorce, assets may be transferred between spouses on a tax-exempt basis. Transfers will not increase or decrease either spouse's contribution room.

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