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Tax & Estate

Tax-free savings accounts (TFSAs): Scenarios

A TFSA is a flexible, registered account that allows Canadians to watch their investments – including interest income, dividend payments and capital gains – grow tax-free. While a registered retirement savings plan (RRSP) is intended for retirement, a TFSA can be effective for achieving pre-retirement, retirement and estate-planning goals.

This *InfoPage* develops six investor scenarios that dig deep into the strategic applications of a TFSA and is a great companion to our *Tax-free savings accounts (TFSAs) InfoPage*, which summarizes the features and benefits of the plan.

Scenario 1

Gwen is a recently graduated professional starting a promising career. For now, should she invest in a TFSA, an RRSP or both?

With a bright future ahead, Gwen can expect to be a strong income earner once she is established, likely reaching the top income-tax bracket in the future. In the meantime, however, she has an entry-level job and looks forward to climbing the income ladder.

Gwen's budget will include new business and household expenses, not to mention student loan payments. She will have to budget carefully in these early working years, which will leave limited money for investments. Under these pressures, she may choose to invest using an RRSP (pre-tax dollars) over a TFSA (after-tax dollars) because more money is invested up front. But, is it really that simple?

While both RRSPs and TFSAs benefit from internal tax sheltering, there is a point at which tax must ultimately be paid: TFSAs being taxed before deposit and RRSPs, registered retirement income funds (RRIFs) and registered annuities being taxed upon withdrawal. Where a person's marginal tax rate (MTR) is the exact same at deposit and on withdrawal, the net spendable funds will be the same in the end, regardless of which plan is employed. It's also important to note that where the tax rate is higher on deposit than on withdrawal, the RRSP will yield a greater net sum; and where the tax rate is lower on deposit than on withdrawal, the TFSA will fare better.

At this early stage in her career, Gwen is at a lower tax bracket than she expects to be upon her retirement, so the TFSA may be the better choice. While investing in the TFSA, her earned RRSP contribution room will carry forward until she moves into a higher tax bracket. In fact, rather than simply making future deposits directly out of her salary and into an RRSP, she could strategically shift the TFSA funds into her RRSP to obtain larger refunds and reduce the tax hit as she moves into higher earning years. By strategically timing the process from TFSA to RRSP to withdrawal, Gwen will effectively arbitrage the tax-bracket system from employment through retirement.

TFSAs compared with RRSPs at a constant MTR

	RRSP	TFSA
Pre-tax income	$1,000	$1,000
Tax on contribution (50% MTR)	N/A	$(500)
Net contribution	$1,000	$500
Growth at 5% over 20 years	$2,653	$1,327
Tax on withdrawal (50% MTR)	$(1,326)	N/A
Net cash	**$1,327**	**$1,327**
Where there is a tax-rate differential between the year you contribute and the year you withdraw	High to low favours RRSP	Low to high favours TFSA

Scenario 2

Pat and Lee are recently married twentysomethings considering ways to save for their new home, potentially making use of a TFSA.

Pat and Lee are generally cautious when it comes to financial matters, even more so in the case of big-ticket items, such as real estate. They will definitely need to build toward a down payment and be comfortable with their ongoing ability to service the steep debt that often accompanies a first-time home purchase.

The Home Buyers' Plan (HBP) is one program that may be used to accumulate such funds. Essentially, it allows each spouse a no-interest loan of up to $35,000 from their respective RRSP funds to go towards a down payment. A key benefit is that the original RRSP deposits come from pre-tax funds, so the $35,000 level can be reached quicker than if after-tax funds are used. But, remember, the HBP loan must be repaid over a 15-year period. If the couple does not make a given annual repayment, tax must be paid on that amount, and the associated RRSP contribution room is not recovered. This could potentially mean using later years' higher-bracket income to service earlier years' lower-bracket tax breaks.

The TFSA offers another avenue for accumulating the down payment, whether as a complement or substitute to the HBP. With a TFSA, there are no minimum or maximum withdrawals nor any required repayments, and unlike RRSPs, the contribution room is fully recovered on withdrawal. As well, for lower-tax-bracket investors, the net contribution via the after-tax TFSA route may not be significantly less than using pre-tax RRSP dollars. In fact, if a lender allows borrowing against the TFSA (keeping those invested funds growing tax-sheltered), the credit facility may be as much or more than that available under the HBP. In the end, even if using the TFSA slightly delays a purchase, that may be a more prudent approach than relying on the HBP alone.

Depending on circumstances, a combination of the two programs may be the preferred route. A careful plan could incorporate future incomes and related tax brackets to ensure that "home sweet home" doesn't become an unsustainable liability.

Scenario 3

Ayesha is returning to the workforce this year. She would like to start saving right away, but will not have any RRSP contribution room until next year. Could a TFSA help?

Ayesha had her last child a few years ago and decided to stay at home until all three of her children were enrolled in school full-time. Prior to her maternity leave, she always made the maximum contribution to her RRSP; however, she has had no earned income over the last four years. Her $60,000 salary this year will entitle her to approximately $10,800 of RRSP contribution room next year, but she wants to take advantage of the familiar RRSP tax-sheltering effect right away rather than losing another year of compounding.

Ayesha could set aside about $100 from each weekly paycheque to deposit into her TFSA throughout the current year. After filing her taxes next April, Ayesha will receive her Notice of Assessment showing her the exact RRSP contribution room she will have earned in the current year.

However, as early as next January, Ayesha could make a withdrawal from her TFSA to contribute over to her RRSP. She will be able to claim the contribution when filing the following year's tax return and receive a substantial tax refund shortly thereafter.

In total, the series of transactions allows for a fairly seamless move from one tax- sheltering plan to another, effectively restarting the RRSP while taking full advantage of the TFSA. Another benefit is that Ayesha can fully recover the TFSA room in the following year for the amount she withdraws.

Scenario 4

Sidney and Lorna want to build their family's wealth for the long term. They want to know how a TFSA fits into their plan.

Sidney and Lorna have been teachers at a private school for their entire careers. They have a daughter, Jocelyn, and do not plan on having any more children. They both come from middle-class families and, in hindsight, are amazed and appreciative of the sacrifices their parents made for them, including paying for their entire post- secondary education.

In fact, the couple has worked with Jocelyn's grandparents to make sure she can also pursue higher education through registered education savings plan (RESP) contributions, trust accounts and outright gifts. Taken all together, it appears that there are more-than-sufficient funds available for Jocelyn to pursue her own goal of becoming a teacher when she starts university as an 18-year-old next year.

Having benefited from such good planning and good fortune, Sidney and Lorna are now looking at how they can take advantage of the TFSA to give Jocelyn a further boost as she moves into her adult life. In particular, they have been thinking about providing Jocelyn with money to fund her TFSA rather than building a lump-sum inheritance for Jocelyn to receive in the distant future.

Let's say that Sidney and Lorna give Jocelyn $3,000 per year for her TFSA, which they will continue to do for the next 21 years until they are fully retired. Given a 6% annual rate of return, their $63,000 will become a tax-free gift of approximately $127,000 by the time Jocelyn is 38. If Jocelyn tops up her annual gift to reach the maximum contribution limit ($6,000 as of 2020), her TFSA will be worth approximately $253,000 – and not a penny will be taxable. Beyond that, Jocelyn could continue to maximize her contributions until she is 65 and retire with more than $1.62 million in her TFSA.

But, don't forget that the annual TFSA contribution room is indexed to inflation, meaning that Jocelyn could actually contribute more, and hopefully accumulate more down the road.

Sidney and Lorna are effectively starting a family fortune that will never be taxed. If all goes well, their grandchildren will not have to make the same financial sacrifices that their parents made.

Scenario 5

Nicole is in the "sandwich generation," responsible for both her young adult children and her aging parents. How can she make the most of a TFSA?

Nicole was widowed recently. Fortunately, she is in reasonable financial shape presently. She is receiving modest benefits from a life insurance policy, she completed a spousal rollover of her husband's RRSP holdings and she earns a healthy income as a nurse. She doesn't need any convincing of the value of a TFSA and intends on using some of the insurance money to fully fund her own plan.

The operative word for her finances is "presently." She has two children in post-secondary schooling, and RESP accounts that are running out of funds. Like her, both kids have a strong work ethic and expect to make it through their programs without going into debt. Nicole plans to provide each of them with money to place into their respective TFSA plans for the next few years to ease the start of their investing and working lives. This will ensure they get early access to tax-sheltered compound growth and will provide a foundation for future investing habits.

Of course, Nicole can't do everything, particularly with her own parents heading into their late 70s in declining health. As a nurse, she is acutely aware of long-term care costs and will likely be supporting her parents in the future. Preparing for that eventuality, she has chosen to use her remaining insurance money to assist her parents to maximize their TFSAs. By helping both her children and her parents to fund their respective TFSAs, Nicole has ensured that all generations of the family will benefit from tax-sheltered compound growth.

Scenario 6

Gordon and Eleanor are looking at how to use a TFSA for their retirement-planning goals.

Though not in the top income-tax bracket, Gordon and Eleanor have earned well and saved well. Now, both in their late 50s, they are looking at ways to facilitate efficient access to their savings.

Gordon is planning on retiring early this year. Without earned income in the future, he will not have RRSP contribution room, although he could still build RRSP value through spousal plan contributions from Eleanor. In addition, she could contribute to his TFSA without concern of running afoul of the spousal income attribution rules.

As a more advanced strategy, it may make sense for Gordon to redeem a sufficient amount of his RRSP to net the desired amount to contribute to his own TFSA, and maybe even to contribute to Eleanor's TFSA. Although Gordon will incur tax on his RRSP redemption, which must inevitably occur anyhow, it will have been at the lowest tax bracket. And, the net funds will go right into another tax-sheltered plan.

This may be the ideal time to make those small RRSP withdrawals, as the couple will need to regularly draw down their RRSPs and RRIFs once Eleanor retires. With particular focus on post-age-65 planning, the availability of TFSA investments in the future may limit the loss of the age-65 income tax credit and will not contribute to the Old Age Security clawback.

Gordon and Eleanor will have to begin drawing down their RRSP when they turn 71. As the drawdowns occur, they can take advantage of their combined TFSA contribution room and continue to benefit from tax-sheltered compound growth. Beyond that, the availability of a spousal rollover will allow the surviving spouse to carry on with their combined TFSA balances.

For more information about this topic, contact your advisor, call us at 1.800.874.6275 or visit our website at invesco.ca.

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