TFSA truth & rumours

Confused about Tax-Free Savings Accounts? You're not the only one. Test your knowledge to see if you know which TFSA facts are true and which are false.

By Sarah Efron | From MoneySense Magazine, September/October 2010

Three months ago, Scott Bowers got a nasty shock. The 34-year-old Barrie, Ont., resident received a letter from the tax man saying he owed an extra $214. What did he do wrong? According to the Canada Revenue Agency, he had over-contributed to his Tax-Free Savings Account (TFSA).

Turns out, he wasn't the only one. A total of 70,000 people received government notices scolding them for shoveling too much money into their TFSAs. Many had to pay a penalty tax, and countless others found themselves spending hours on the phone explaining their plight to unhelpful CRA staff, or filling out reams of paperwork.

When Tax-Free Savings Accounts were first introduced in January 2009, Canadians loved them—after all, your money could grow faster and there was no penalty for withdrawals. But using them correctly can be complicated, and even some of the pros are confused. We've heard several stories of financial advisers giving TFSA advice to their clients that's confusing, misleading or just plain wrong.

It's a shame, because TFSAs can save you plenty of cash if you use them right. How can you avoid over-contributing and get the most out of your TFSA? Simple. Test your knowledge with the true or false statements that follow, and let MoneySense turn you into a TFSA expert in just 15 minutes.

TFSAs are a type of high-interest savings account, true or false?
False. While financial institutions run campaigns encouraging people to open a TFSA high-interest savings account, that's not your only option. "This misconception stems from the name of the product—Tax-Free Savings Account," says Gordon Pape, author of The Ultimate TFSA Guide.

You can open a TFSA in the form of a high-interest savings account, but if you open a TFSA through your discount brokerage, you can put pretty much any investment you want in it: GICs, stocks, bonds, mutual funds and exchange-traded funds (ETFs). Like an RRSP, a TFSA account is not a type of investment product, it's an account with specific tax properties that's registered with the CRA.

You get a tax refund when you contribute to a TFSA, true or false?
False. Unlike with an RRSP, you do have to pay income tax on money that you deposit into your TFSA account. The tax savings come from growth on your investments—if you receive interest or dividends from investments inside a TFSA, you won't have to pay tax on that income. Nor will you have to pay tax on capital gains within your account.

You can contribute up to $5,000 a year to a TFSA, true or false?
True. As long as you're a Canadian resident over 18 years old, you can contribute up to $5,000 a year.

If you don't use your contribution room this year, you can use it next year, true or false?
True. Unused contribution room for your tax-free savings account accumulates and you can use it in future years.

You have to pay taxes on money you withdraw from a TFSA, true or false?
False. It helps to think of the TFSA as a mirror image of the RRSP. With an RRSP you don't pay tax on money that goes in, but you do pay tax on money that comes out. With a TFSA, you do pay tax on money that goes in, but you don't pay tax when it comes out.

You can take money out of a TFSA and put it back in later, true or false?
True. But make sure you know the rules. If you withdraw money, you can recontribute it, but not in the

same calendar year. As many unlucky souls found out, if your contributions exceed your limit for the year, you'll be subject to a 1% tax each month on the amount of the over-contribution. This applies even if you made withdrawals from that account during the year. For example, let's say your TFSA contribution limit for the year is $5,000. If you put $5,000 into your account, then withdrew $2,000, then later that same year, you deposited another $2,000, then you would be $2,000 over the limit.

In late June, Finance Minister Jim Flaherty issued a statement acknowledging that there has been a lot confusion around this issue. People who had received letters from the CRA saying they had over-contributed were told they might avoid paying the tax if they provided the CRA with more information about their circumstances by August 3. The CRA is now reviewing this information and will make decisions on an individual basis.

If you received a over-contribution letter and you didn't respond, it's not too late. Even though the August 3 deadline has passed, the CRA says you should still respond, either by paying the tax or sending in more information to dispute the tax. The CRA also advises that anyone who has over-contributed to their TFSA in 2010 to withdraw the excess funds as soon as possible to reduce future penalties.

If your investments decline in value, you can add more money to the account, true or false?
False. You can only put in an amount up to your accumulated contribution room, regardless of how your investments perform. So if your stocks get clobbered, you'll have to wait until next year to top up the account if you have no unused contribution room left.

The Canada Revenue Agency will give you an annual statement showing how much you can contribute to your TFSA, true or false?

True. Your notice of assessment shows know how much TFSA contribution room you have at the beginning of the next tax year. This means that your 2010 Notice of Assessment will show how much you can contribute as of January 1, 2011.

You can only have one TFSA account, true or false?
False. You can open as many TFSA accounts as you like, but be careful. You are allowed to split your contribution room between two or more TFSA accounts at different institutions, but the combined contributions must add up to less than your annual limit.

You should also be careful when transferring money from one TFSA to another. If you just withdraw the cash from your old TFSA and deposit it in a new one, that money could be counted as a fresh contribution and might put you over your limit. Instead, have your new financial institution transfer in the contents of your old TFSA. "You won't run into any problems if you do it that way," says Gordon Pape.

TFSAs are a great way to save for short-term savings goals like buying a new car, true or false?
True. At first, TFSAs are often used as emergency savings accounts, which is a fine idea. With your contributions capped at just $10,000 to date, it was hard to use them for much else.

But as the amount you can hold in your TFSA grows, it can be used for more ambitious goals. You can use your TFSA to accumulate money for things such as a trip around the world or new car. Unlike RRSPs, you won't be taxed when you take out the money, and your money will accumulate faster than in a regular account due to the tax-free growth.

TFSAs are the best way to save for retirement, true or false?
False. There are exceptions, but for most people, RRSPs are still the first choice for building your retirement nest egg. "I've run the calculations for tons of different clients, and in virtually every one, it makes the most sense to use an RRSP," says Karin Mizgala, a fee-based financial planner in British Columbia.

That's because with an RRSP, you get the income tax back on the money you contribute. When you get your refund, it can be invested right away. And when you cash out your RRSPs in your golden years, you'll probably be in a lower income bracket, so you'll pay less tax than you would have paid when you put the money in.

Because of this, TFSAs are better used once you've maxed out your RRSPs, or if you want to invest money that you'll spend before retirement.

One exception is if you think you might be making more money after you retire than you did when you were working. If you make less than $35,000 a year when you're working, for example, that's a real possibility thanks to government retirement benefits, so you're probably better off saving in a TFSA. And if you're planning on retiring in a jurisdiction with higher tax rates, or you will be receiving a generous pension while working at another job in retirement, you may also want to use the TFSA for part of your retirement savings.

You can use your TFSA as loan collateral, true or false?
True. You aren't allowed use the assets inside your RRSP as collateral for a loan, but you can use your Tax-Free Savings Account to backstop your borrowing. This could come in handy in a scenario where you need a cash advance to deal with an emergency, but your money is tied up inside a locked-in GIC in your TFSA. You can also borrow money to invest in your TFSA, although you can't write off the interest as a tax deduction.

You can dump a losing stock into your TFSA to claim a capital loss, true or false?
False. For a while, the financial blogs were buzzing with what looked like an ingenious method for triggering a capital loss without selling a stock. But it turns out the tax man doesn't allow it.

This is how the scheme was supposed to work: let's say you had some impressive capital gains on your stock portfolio one year, and you were looking for some capital losses to offset them, so you could pay less tax. Normally, the only way to trigger those losses would be to sell off stocks that had lost value. The rumour going around was that if you didn't want to sell your losing stocks (because, say, you thought they were going to bounce back next year), you could instead dump them in your TFSA, which would allow you to declare the loss, even though you still hold the stock.

Theoretically, it should work that way, because when you transfer a winning stock to your TFSA, it does indeed trigger a taxable capital gain. But unfair as it sounds, the Canada Revenue Agency simply does not allow you to claim a capital loss on TFSA contributions. You can sell the stock, wait 30 days, and then buy it back inside your TFSA account, but check the superficial loss rules first.

You should hold bonds and GICs inside your TFSA, because the interest they produce is normally taxed at a higher rate than other investment income, true or false?
True. Interest from savings accounts, bonds and GICs is taxed at a higher rate than dividends or capital gains, so you benefit more by keeping them in a TFSA.

However, Gordon Pape notes that interest rates are low right now, so you may still get a better bang for each dollar's worth of investments by keeping stocks, ETFs or mutual funds in your tax-free savings account. "Even though 50% of the capital gains are already tax-free, the other 50% are taxed. If you make a significant capital gain, you're going to be able to keep the whole thing," Pape says.

It's also important to remember that you shouldn't let such tax issues dictate which types of investments you buy in the first place. Other factors, such as your risk tolerance and time horizon, take precedence. If you're saving up to buy a car in the short term, for instance, you should go with a high-interest savings account or redeemable GICs. However, if you're investing for the long term and can handle the market's swings, stocks, mutual funds or ETFs will be a better bet.

You can hold a Couch Potato portfolio inside a TFSA, true or false?
True. But the TFSA contribution limit will affect how you set it up. As of this year, the maximum amount of contribution room you could have is $10,000 (your limit will hit $15,000 in 2011). With a portfolio of this size, you'll want to set up your Couch Potato Portfolio using index mutual funds, such as TD's e-Series funds, rather than exchange-traded funds (ETFs). In general, says MoneySense index investing columnist Dan Bortolotti, if you have less than $30,000 in your portfolio, the e-Series funds are more cost-efficient than ETFs. (For more on this, see Become a Couch Potato investor with less than $5,000.)

You should designate your spouse as a beneficiary, true or false?
False. If you want your spouse or common-law partner to have access to your account after your death, he or she should be designated as the "successor holder." That way your spouse will automatically take control of the account after your death, meaning that he or she will be able to withdraw the money tax-free or keep the investments in the account. (Note that it works differently in Quebec).

If you want the assets in your account to go to someone besides your spouse—a child, a friend or a charity—you can name them as the "beneficiary" of your TFSA. They will receive the assets tax-free, but the account will be shut down, and they will have to pay tax on any profits earned after your death and before the account is closed.

In fact, you can name both a successor holder and a beneficiary—for example, a man could name his wife as a successor holder and his child as beneficiary, meaning his wife would get the money after his death. Upon the wife's death, as long as she didn't change the beneficiary, the funds would then be passed to the child.

TFSAs can be used to bypass probate tax on inheritance, true or false?
True. TFSAs are a great way to pass on wealth to your heirs in a tax-efficient manner—not only will they avoid paying capital gains tax on the growth of your investments before your death, but if you designate them as beneficiaries, the money will bypass your will. This means it won't be subject to probate tax, says Allison Marshall, a financial advisory consultant with RBC Dominion Securities.

Unfortunately, there is still a lot of confusion regarding inheritance rules, even among financial professionals. This is partly because provincial rules regarding TFSAs were slow to roll out. If you set up your TFSA early on, you might want to go back to your financial institution and check that you completed all the paperwork properly.

You can use TFSAs to income split between couples, true or false?
True. Normally, investment income and capital gains are taxed in the name of whoever earned the money used to buy the investments. But for investments inside a TFSA, that's not an issue—because the income and capital gains aren't taxed at all. Thus, "the main breadwinner in a couple could open a TFSA account in his or her spouse's name, then give the spouse money to put into account," explains Karin Mizgala. By having two TFSAs, you will have doubled your contribution room, and if the higher income earner effectively contributes to both accounts, over the years it could result in a sizable reduction of the couple's tax bill.

Withdrawals from your TFSA will result in clawbacks from government benefits such as Old Age Security, true or false?
False. One of the great things about TFSAs is that when you take money out, it doesn't count as income. That means you don't pay tax on it, it won't affect your GST credit or Employment Insurance, and you won't face clawbacks on your Guaranteed Income Supplement or Old Age Security. It's another reason why people earning low salaries are better off saving inside a TFSA than an RRSP.