

AIM Trimark Investments federal budget analysis 2008

A leader in the timely and thorough preparation of tax information on a range of issues, AIM Trimark has been providing a customized analysis of the federal budget for over a decade. Prepared from within the budget lockup in Ottawa by Jamie Golombek, AIM Trimark's Vice President of Tax & Estate Planning, the 2008 edition selectively focuses on several specific budget elements that will have the biggest impact on your personal finances and investments.

Tax-Free Savings Accounts

Undoubtedly, the biggest treat for investors in the 2008 federal budget was the introduction of a new savings vehicle that will allow Canadians to save money, not just for retirement but for any purpose, on a completely tax-exempt basis. Starting in 2009, Canadians will be able to contribute to a Tax-Free Savings Account (TFSA). This new account was likely introduced to allow the Conservatives to at least partially address their 2006 pre-election promise to eliminate the capital gains tax when the proceeds are reinvested.

The TFSA is essentially a "tax pre-paid savings plan," the term used by the previous Liberal government when it announced in its 2003 budget that it was studying the merits of introducing such a plan. (That government never followed through). "Pre-paid" refers to the fact that the tax on the contributions is paid in advance, as discussed below.

According to the government, the TFSA is a "flexible, registered general-purpose account that will allow Canadians to earn tax-free investment income."

So, how will it work?

Who is eligible?

Anyone who is at least 18 years old will be allowed to open a TFSA. The only requirement is that the individual have a Social Insurance Number when the account is opened. There will be no limit on how many TFSAs you can set up.

How much can I contribute?

The amount you can contribute to a TFSA will be based on your "TFSA contribution room." Starting in 2009, everyone who is at least 18 years old will begin to accumulate \$5,000 (to be indexed annually, rounded to the nearest \$500) of TFSA contribution room. This TFSA contribution room will be cumulative and will be carried forward indefinitely to future years.

For example, let's say you can afford to contribute only \$2,000 in 2009. In 2010, your TFSA contribution room will be \$8,000 (\$3,000 carried forward from 2009 and \$5,000 for 2010).



Perhaps the most interesting twist in these rules is that, unlike the RRSP system, any amounts withdrawn from your TFSA in a particular year will be automatically added to your TFSA contribution room for the following year, allowing individuals who withdraw TFSA funds to re-contribute an equivalent amount in a future year.

As with RRSPs, any excess contributions beyond the TFSA contribution limit will be taxed at 1% per month.

How will TFSAs be taxed?

Unlike RRSPs, but similar to RESPs and the recently-introduced Registered Disability Savings Plan, contributions to a TFSA are meant to come from after-tax funds (hence “tax pre-paid”) and therefore will not be tax deductible from income. The big advantage is that any income and gains on investments held within a TFSA won't be taxed either while inside the TFSA or **upon ultimate withdrawal**. This helps to address the problem of the double taxation of savings.

Effect on income-tested government benefits

One of the biggest criticisms of the current RRSP system is that when the funds are withdrawn upon retirement, not only are they taxed at the retiree's personal marginal tax rate, but in many cases, they affect the retiree's eligibility for income-tested government benefits and credits, such as the Age Credit, the Guaranteed Income Supplement (GIS) or even Old Age Security (OAS) benefits.

The government announced that withdrawals from the TFSA, since they are not considered to be “income,” will have no impact on government benefits or credits, such as GIS or OAS, or on the Canada Child Tax Benefit or the Goods and Services Tax Credit.

What can I invest in?

A TFSA will be allowed to invest in basically the same broad list of qualified investments currently permitted for RRSPs, including stocks, bonds, mutual funds, etc.

What if I borrow to invest in my TFSA?

Since the income earned inside a TFSA along with TFSA withdrawals are non-taxable, you won't be able to write off any interest expense on funds borrowed for the purpose of investing in a TFSA.

Unlike RRSPs, which cannot be used as collateral for a loan (unless you want your RRSP deregistered and immediately taxed), TFSA assets can be used as collateral, which may facilitate investors in obtaining secured credit at more favourable rates.

Can I give my spouse or partner funds to contribute to a TFSA?

Normally, the attribution rules contained in the Income Tax Act block attempts at splitting either income or capital gains between spouses or partners by attributing such income or gains back to the original spouse or partner.

The federal budget introduces an exception to the attribution rules stating that the rules will not apply to any income or gains earned in a TFSA derived from a spouse or partner's contributions.

What happens upon death?

The fair market value of the TFSA on the date of death will be received by the estate on a tax-free basis, but any income or gains accruing after the date of death will be taxable.

Individuals will be able to name a surviving spouse or partner as a “successor account holder,” in which case the TFSA will continue to be tax-exempt. Alternatively, the assets of a deceased individual’s TFSA can be transferred to a surviving spouse or partner’s TFSA without affecting the surviving spouse or partner’s own existing TFSA contribution room.

What happens upon separation or divorce?

On the breakdown of a marriage or a common-law partnership, any amount from the TFSA of one spouse or partner can be transferred to the TFSA of the other while maintaining the tax-exempt status. Note that this transfer will not re-instate the contribution room of the transferor spouse or partner, nor will it be counted against the contribution room of the transferee spouse or partner.

What if you become a non-resident?

If you become a non-resident, you can still hold your TFSA and continue to benefit from the tax exemption on investment income and withdrawals, but no contributions will be permitted, nor will TFSA contribution room continue to accrue.

TFSA vs. RRSPs

So, assuming you’ve got limited funds, which one do you choose: the TFSA or the RRSP? That’s a good question and one that will be analyzed extensively well before the 2009 implementation date.

While the two plans are meant to be tax-neutral (see chart below), RRSPs will tend to make more sense when the tax rate upon withdrawal is expected to be lower than the tax rate upon original contribution. Conversely, TFSAs will work out better if your tax rate (including the effect of RRSP withdrawals on reduced income-tested benefits) will be higher upon ultimate withdrawal than it was when you contributed.

	TFSA	RRSP
Pre-tax income	\$ 1,000.00	1,000.00
Tax (40%)	(400.00)	N/A
Net contribution	\$ 600.00	1,000.00
Growth at 6%/20 years	1,924.28	3,207.14
Tax upon withdrawal	–	(1,282.85)
Net cash	\$ 1,924.28	1,924.28

Note that the chart above assumes forgone consumption (savings) is \$600. In other words, in the RRSP scenario, while the individual contributes \$1,000 and receives a 40% tax refund, he or she is still sacrificing net consumption of \$600.

Increased flexibility for federal LIFs

Canadians who have funds “locked up” inside of federal Life Income Funds (LIFs) will now have greater access to their money beyond the current annual maximum withdrawal limits.

The 2008 federal budget proposes to allow individuals to access funds from their LIFs in three circumstances: small balances, financial hardship and one-time unlocking.

Small balance withdrawal

Individuals who are at least 55 years of age with LIFs worth less than \$22,450 (to be indexed to the average industrial wage) will be able to wind up their accounts or convert them to another tax-deferred savings vehicle, such as an RRSP or RRIF, in which there are no maximum withdrawal limits.

Financial hardship withdrawal

Any LIF holder, regardless of age, facing “financial hardship” (low-income individuals or individuals with high disability or medical-related costs) can unlock up to \$22,450 (also to be indexed).

One-time unlocking

In perhaps the most dramatic change, the 2008 budget proposes to allow individuals who are at least 55 years of age to “unlock” up to 50% of their LIF holdings and transfer the funds into another tax-deferred savings vehicle, such as an RRSP or RRIF, where there are no annual maximum withdrawal limits.

This one-time unlocking provision follows similar moves in recent years among the provinces. Alberta and Manitoba also allow a 50% one-time unlocking while New Brunswick and Ontario allow 25% to be unlocked. Only Saskatchewan has moved to a 100% unlocking system.

Registered Education Savings Plans (RESPs)

The government is extending some of the time limits associated with RESPs to provide additional flexibility to students. Under the current rules, contributions to an RESP can be made for 21 years following the year in which the plan is entered into. An RESP must be terminated by the end of the 25th year following the opening of the plan.

The federal budget announced that it would immediately extend these deadlines by 10 years. You will now be able to contribute to an RESP for up to 31 years. The plan needs to be terminated by the end of the 35th year following the year of opening.

The government has also relaxed the rules surrounded Educational Assistance Payments (EAPs). Currently, a student could only receive an EAP if, at the time of the payment, he or she was enrolled as a student in a qualifying post-secondary program.

The budget now proposes a six-month “grace period” for receiving EAPs. This rule would allow an RESP beneficiary to receive EAPs for up to six months after ceasing to be enrolled in a qualifying program.

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