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The Tax-Free Savings Account Is a Real Winner

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In a surprise addition to the 2008 federal budget, the Tax-Free Savings Account (TFSA) was born. Ottawa introduced the new account to encourage Canadians to save more for their future and, while net inflows and account openings have been much larger than expected, the rise in the Canadian savings rate this year might have more to do with the aftermath of the financial crisis than the introduction of a new savings vehicle. Personal savings rates have risen sharply in 2009 in virtually all major industrial nations, especially in those such as the U.S and U.K. that suffered a meltdown in home equity as well as financial asset values. The dramatic loss of wealth has scared almost everyone into tightening their belts, spending less of their income and refraining from taking on more debt. While that has not been possible for many families, especially those plagued by job loss, on average, Canadians are now saving 4.8% of personal income, compared to an average rate of only 3.7% in 2008 and 3.8% over the first five years of this decade when the economy was booming.

In the wake of the crisis and ensuing recession, financial institutions everywhere tightened their credit standards to mitigate rising loan losses. Fortunately, credit has been more readily available in Canada than in most other countries as Canadian banks weathered the storm far better than banks elsewhere. Having been well capitalized and far more prudent, Canadian banks have been able to keep their loan windows open, although the recession has taken its toll on household borrowing qualifications and has reduced the demand for credit. So while the rise in the Canadian savings rate cannot be attributed solely to the introduction of the TFSA, it has certainly proved to be an attractive and popular way for more prudent households to feather their nest egg.

More Popular than Expected

As of January 1, 2009, the new rules allowed Canadian residents over the age of 18 to contribute up to $5,000 per year to a TFSA, which could be opened at any financial institution. Any unused contribution room will cumulate and can be used anytime in the future. There are no penalties for withdrawal; money can be withdrawn at any time and amounts withdrawn can be subsequently recontributed. The flexibility of the account makes it very attractive compared to an RRSP. This is the most significant change to our tax system regarding savings since RRSPs were introduced in 1957. Overall, the program is considered to be a smart way for the government to encourage people to save for retirement and to reduce their personal tax burden.

TFSAs have proved to be more popular than Ottawa expected. One-in-five households have opened a TFSA, a relatively strong take-up rate given its short lifespan. Between January 1 and the end of June, about 3.6 million people set up a TFSA, totalling $12.4 billion, according to an analysis by Toronto-based financial research firm Investor Economics and pollster Ipsos Reid. This compares with $33.3 billion in RRSP contributions in 2008, with about 6.2 million people now holding $631 billion in RRSPs, according to StatsCan data. The take-up rate for TFSAs can only increase going forward as annual contribution limits are raised, and as people take advantage of unused contribution room from previous years.

Canadians aren't gambling with their TFSA savings. 94% of assets held at bank TFSAs are savings account deposits or term deposits. Many savers appear to be unaware that they can invest their TFSA contributions in stocks, bonds and other financial assets, as well as in short-term deposits and GICs. Opening a self-directed TFSA at an investment dealer offers the widest variety of investment options.

The TFSA vs RRSP Decision

Deciding on how the TFSA should be positioned relative to other savings opportunities such as debt repayment, RESPs, and RRSPs depends on individual personal finances and goals. The budget says, *"the net after-tax rates of return on TFSA and RRSP savings are equivalent when effective tax rates are the same at the time of contribution and withdrawal,"* meaning the tax deduction from RRSP contributions is similar to the savings from withdrawing funds tax free from a TFSA. The TFSA and RRSP are benefit-neutral if your personal tax rate is the same in the contribution and withdrawal periods, but the RRSP comes out ahead if the tax rate is higher in the contribution period, as the following calculations will show.

For those people, especially higher-income earners, who have extra funds after reaching their RRSP contribution limit, it offers an attractive way to reduce taxes on income-bearing assets and capital gains. TFSA customers tend to be older and more affluent, not surprisingly, suggesting younger people are using whatever savings they have to first pay down debt.

Here is an Example

In the simplest terms, for those who can save, the choice between a TFSA and an RRSP depends on the tax rate at contribution time vs at withdrawal time. In general, the TFSA is more attractive than an RRSP for two groups. Those in a low-income stage of their life, like students and young couples without kids, who have excess cash after paying their bills and drawing down debt. RRSPs are generally more attractive for people in their peak-earning years that expect their tax rates to decline when they stop working. Affluent people who have money to save after maxing out their RRSP contribution will also find the favourable tax treatment of TFSAs far more beneficial than non-registered investments.

The only caveat is that with both accounts, while returns are not taxable (until withdrawal in the case of the RRSP), capital losses have no beneficial tax treatment.

Here are some calculations to clarify these tax-treatment principles:

- If you will pay the same income tax rate at contribution and withdrawal, your after-tax return from an RRSP and a TFSA will be equal (although you do get the income-tax deduction from an RRSP up front in the year in which you make your contribution) while you do not enjoy the tax benefits of the TFSA until withdrawal. In both accounts, earnings accumulate tax free.
- If your tax rate is higher at contribution time than at withdrawal time, which is the case for many middle-income households, the RRSP wins.
- If your tax rate is lower at contribution time than at withdrawal time, the TFSA wins.

But both accounts provide higher after-tax returns than non-registered investments.

	Same Tax Rate Through Time		**Higher Tax Rate at Contribution**		**Higher Tax Rate at Withdrawal**	
	TFSA	**RRSP**	**TFSA**	**RRSP**	**TFSA**	**RRSP**
Gross Contribution	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000
Tax Rate at Contribution	46%	46%	46%	46%	30%	30%
Net Contribution	$540	$1,000	$540	$1,000	$700	$1,000
Rate of Return	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Years in Plan	20	20	20	20	20	20
Value at Withdrawal	$1,433	$2,653	$1,433	$2,653	$1,857	$2,653
Tax Rate at Withdrawal	0%	46%	0%	30%	0%	46%
Net Withdrawal	**$1,433**	**$1,433**	**$1,433**	**$1,857**	**$1,857**	**$1,433**

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