BMO NESBITT BURNS

Having a TFSA works. Get one working for you.

The benefits and flexibility of a Tax-Free Savings Account (TFSA) make it ideal for millennials (also called "Generation Y") who may be saving for multiple financial goals. While TFSA contributions are not tax deductible, the contributions grow tax-free, can be withdrawn tax-free at any time, and there are no restrictions on how you use the funds once they're withdrawn from your TFSA.

Whether you're saving for a new car, advanced educational degree, home purchase, your child's education or even your retirement, a TFSA can help you reach your financial goals sooner.

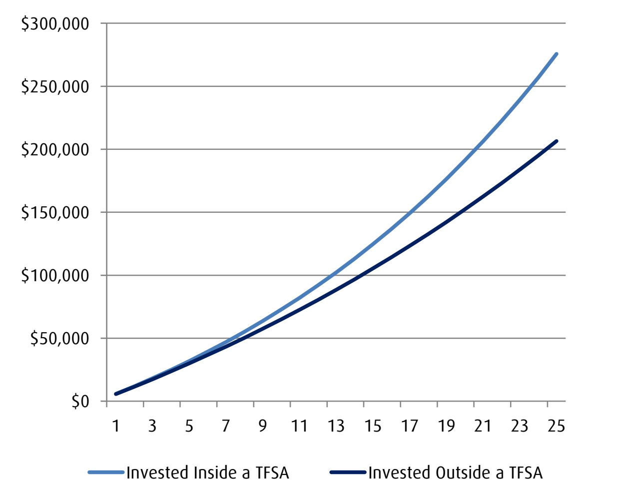
Contributions

Once you reach the age of majority,[1] you can begin making TFSA contributions. TFSA contributions are currently $5,500 annually and indexed to inflation (increases in $500 increments). Unused contribution room – dating back to 2009 when TFSAs were first introduced, or the year you turned 18 – carries forward and can be used in a future year. If you've never contributed to a TFSA, your contribution limit for 2014 could be as high as $31,000.

Withdrawals

Withdrawals from your TFSA are tax-free and any amount withdrawn in the current year will be added back to your TFSA contribution room at the beginning of the following year. For example, let's assume your TFSA is worth $30,000 and you withdraw $10,000 in August 2014. On January 1, 2015, your TFSA contribution limit will increase by $15,500 ($10,000 withdrawn in 2014, plus your 2015 TFSA contribution room of $5,500). In addition, TFSA withdrawals won't impact your eligibility for federal income-tested benefits and credits such as employment insurance benefits, child tax benefit and the GST credit.

Benefits of Tax-Free Growth in a TFSA



Assumptions: $5,500 annual contributions earning a five per cent annual rate of return. Contributions are made on January 1st of each year for 25 years. Income generated outside the TFSA is taxed at a 40 per cent marginal tax rate.

The graph compares the growth of annual $5,500 contributions in a TFSA versus saving $5,500 annually in a non-registered investment account. Assuming a five per cent rate of return, after 25 years the TFSA will grow to $275,624, while the non-registered account grows to only $206,542. As a result of the tax-free growth of the TFSA, you'd have $69,000 (or 33 per cent) more to fund your financial goals.

Investment options

Generally, investments that qualify for an RRSP can also be held in a TFSA, including equities, bonds, mutual funds, GICs and exchange traded funds (ETFs).

TFSA or RRSP – Determining the best savings option for you

Since the introduction of TFSAs, many Canadians have questioned whether to contribute to a TFSA or RRSP for their retirement savings. While both plans allow your investments to grow tax-free inside the plan, there are major differences in the tax treatment of contributions and withdrawals. TFSA contributions are not tax-deductible and all withdrawals are tax-free. With an RRSP the opposite is true: contributions are tax-deductible and all withdrawals (including any income earned while inside the RRSP) are taxed as ordinary income when withdrawn.

As a result, when deciding whether to make a TFSA or RRSP contribution, the most important financial factor is your marginal tax rate today, and your expected marginal tax rate in retirement. The table below compares three scenarios where a $5,500 contribution is made to a TFSA and RRSP and the contribution earns a five per cent rate of return for 20 years. At the end of 20 years, the funds are withdrawn from the plan.

If your marginal tax rate is 40 per cent at the time of the TFSA and RRSP contributions and withdrawals, your tax savings will be identical. However, if you're in a higher tax bracket when making your TFSA and RRSP contributions than when making your withdrawals, the RRSP provides more tax savings than the TFSA. However, if you're in a lower tax bracket when making your TFSA and RRSP contributions than when making your withdrawals, the TFSA provides more tax savings than the RRSP.

If you expect your marginal tax rate to be lower when you retire, then an RRSP is generally more beneficial. If you expect your marginal tax rate to be higher in retirement than it is today, then contributing to a TFSA may be the better option.

It's also important to note that for many, an RRSP offers a higher contribution limit than a TFSA. The RRSP contribution limit for 2014 can be as high as $24,270, whereas the TFSA contribution limit is $5,500. Ideally investors should maximize contributions to both plans to take advantage of the income tax savings benefits. However, from a financial standpoint, this may not always be possible. While everyone's situation is

	Scenario 1		Scenario 2		Scenario 3	
	Marginal Rate 40% when contributed 40% when withdrawn		Marginal Rate 40% when contributed 20% when withdrawn		Marginal Rate 20% when contributed 40% when withdrawn	
Plan	**TFSA**	**RRSP**	**TFSA**	**RRSP**	**TFSA**	**RRSP**
Pre-tax Income	$5,500	$5,500	$5,500	$5,500	$5,500	$5,500
Income Tax Payable	$2,200	n/a	$2,200	n/a	$1,100	n/a
Net Contribution	$3,300	$5,500	$3,300	$5,500	$4,400	$5,500
Value 20 Years Later @ 5% Growth	$8,756	$14,593	$8,756	$14,593	$11,675	$14,593
Income Tax Payable Upon Withdrawal	n/a	$5,837	n/a	$2,919	n/a	$5,837
Net Withdrawal	**$8,756**	**$8,756**	**$8,756**	**$11,674**	**$11,675**	**$8,756**

Please note: The RRSP withdrawal is for comparison purposes only as actual withdrawals would generally occur after the RRSP is converted to a Registered Retirement Income Fund (RRIF).

unique, the following guidelines can assist you in deciding between a TFSA or RRSP contribution:

- If you're in the top marginal tax bracket, maximize your RRSP contribution first, and then contribute excess funds to your TFSA to build your retirement assets. Use your income tax refund to top-up your TFSA for continued tax-free growth.
- If you're just starting your career, you may want to consider delaying your RRSP contributions until you're in a higher tax bracket. The RRSP tax deduction won't save you as much tax today as it might in the future. Instead, contribute to a TFSA for tax-free growth and later, when you're in a higher tax bracket, consider withdrawing funds from your TFSA to make an RRSP contribution and capitalize on the larger tax deduction. You can then use your income tax refund to make a TFSA contribution.

Other important factors to consider include:

- When it comes to saving, RRSPs can offer a psychological advantage. Most people are hesitant to make withdrawals due to the tax consequences. A withdrawal from your RRSP will result in the amount being added to your earned income for the year – and you will lose the contribution room forever. Since TFSA withdrawals are easy to make and tax-free, you may be more inclined to make a withdrawal from your TFSA when you need funds.
- If you're going to receive a generous company pension when you retire, a TFSA may be more advantageous. Any RRSP/RRIF withdrawals will be added to your income – along with your pension income – and could put you in a higher tax bracket, triggering the claw back of Old Age Security (OAS) payments. In 2014, OAS benefits start being clawed back when your net income exceeds $71,592.

While the plan you contribute to may change from time-to-time, depending on your income and financial goals, a general rule of thumb would be that if you contribute to an RRSP, use the resulting tax refund wisely, and if you contribute to a TFSA, try not to withdraw funds unless necessary – especially if you are using the account to save for retirement.

Planning opportunities

TFSAs are ideal for implementing a variety of planning strategies, including:

- Income splitting – You can gift funds to your spouse or common law partner (spouse) to allow your spouse to contribute to his or her own TFSA (subject to your spouse's personal TFSA contribution limit). Income earned within a spouse's TFSA will not be attributed back to you.
- Consider holding investments in your TFSA that would otherwise be taxed at high rates outside a registered account, such as interest income.

Stay connected and keep informed of timely financial planning topics by joining the BMO Wealth Management LinkedIn page.

Open your TFSA today

As a millennial, you'll set many financial goals for your future. By opening a TFSA today you'll benefit from a plan that provides tax-free growth and offers the flexibility you'll need to meet multiple financial priorities over your lifetime.

Your BMO Nesbitt Burns Investment Advisor will work with you to develop a financial plan that includes effective savings strategies to help you attain your financial goals and objectives. For more information about TFSAs, please contact your BMO Nesbitt Burns Investment Advisor.

[1] Individuals must be the age of majority in their province of residence to open a TFSA with BMO Nesbitt Burns. In BC, NS, NB , Newfoundland, Yukon, Northwest Territories and Nunavut, the age of majority is 19.

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