With Canada’s Deficit at $343 Billion, Is the TFSA in Danger?

Description

Last week, news broke that Canada’s fiscal deficit was projected to hit $343 billion. The news came from a long awaited fiscal snapshot published by the federal government. The document showed that COVID-19 emergency measures and lower revenue contributed to unprecedented shortfalls in 2020. While the $343 billion deficit was only a projection, it appears likely to materialize as government spending on COVID-19 emergency benefits continues.

In light of this, we have to consider what measures the government will take to pay for the deficit. A $343 billion increase in debt will create massive interest expenses that will have to be covered in the future.

Eventually, they’ll have to be paid for by higher taxes, or fewer tax exemptions. In such a situation, Canadians may have to brace for tax increases. They may also see a hit to their tax-sheltered accounts, such as Tax-Free Savings Accounts (TFSAs).

The government may look for ways to increase tax revenue

Whenever a government seeks to increase tax revenue, it has two basic options: higher taxes or fewer tax exemptions

The first increases the amount of revenue taken in on taxable income, the second increases taxable income itself.

As far as higher taxes go, the government could increase personal and corporate income tax. Both of these would have significant effects on investors. Higher personal taxes mean less money to invest, higher corporate taxes means worse corporate earnings. In either case, that means less money in investors’ pockets.

When it comes to eliminating tax exemptions, governments also have plenty of options. These include eliminating deductions, credits and recovering money from overseas corporations. In the aftermath of the great recession, several U.S. states got rid of tax exemptions to boost revenue, which was then on the decline. It's hard not to draw parallels to the situation Canada is in now.

Will the TFSA be on the chopping block?

While there is as yet no evidence that the CRA plans to come after the TFSA, it seems like an obvious place for them to look. Tax increases that affect everyone are usually unpopular; reducing tax exemptions for an account like the TFSA might arouse less pushback.

The big problem is that TFSAs reduce the government's tax revenue. Tax sheltered gains means less revenue for the government. In a time of ballooning deficits, that can be a problem.

To illustrate this, let's imagine that you bought $10,000 worth of **Shopify Inc** (TSX:SHOP)(NYSE:SHOP) at its IPO date, and held it to today. Shopify closed at $34.5 on its first day of trading; it's now worth $1,400. So you'd realize about a $400,000 gain on that position if you cashed out. By holding it in a TFSA, you would not pay a penny of income tax on it.

Outside of a TFSA, you'd probably pay close to $100,000. Half of a capital gain is tax-exempt, the other half is taxed at your marginal tax rate. Because of the enormous size of the return just mentioned, you'd be close to the highest tax bracket in most provinces. So you'd likely pay close to 50% on the taxable half of your capital gain.

As you can see, TFSAs spare you from paying big taxes to the CRA, which is one reason the agency may seek to limit TFSA tax exemptions, or perhaps bring in less new contribution room in 2021. The good news is, we've seen no evidence yet that the CRA is considering doing this. But you'd be wise to prepare for it.

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