What is a Tax-Free Savings Account (TFSA)?

Description

When it comes to saving for retirement, Canadians have a unique choice: the Tax-Free Savings Account (TFSA). TFSAs are extremely flexible, and their tax advantages can help Canadians save even more. If you want an all-purpose savings account, the TFSA could be the right choice for you.

To help you decide, let's break down how they work and how you can open one.

What is a tax-free savings account?

A tax-free savings account (TFSA) is a registered retirement account that allows you to save and invest without paying taxes on interest or gains.

Though it's called a "savings account," TFSAs can hold numerous investments, including stocks, bonds, exchange-traded funds (ETFs), and mutual funds. Canadians above 18 years old can open a TFSA, and they can withdraw money from it for any purchase, whether it's retirement, a new car, a house, or even a vacation.

How does a TFSA work?

Unlike simple savings accounts, which grow your money by a meagre rate, TFSAs allow you to invest in numerous securities, including stocks, bonds, real estate, ETFs, and mutual funds. Think of your TFSA as a brokerage account that allows your interest and earnings to grow tax-free.

The tax-free component is crucial: you'll pay *zero* taxes on investment income. It doesn't matter if your investments grow from $5,000 to $500,000. As long as your investments are sheltered in a TFSA, the CRA won't tax you on money you withdraw.

That said, you do have an annual limit on how much you can contribute. For 2023, for example, you can contribute a maximum of $6,500 (up from $6,000 in 2022)[1]. The good news—any unused contribution space will roll over into the next year. So, if you only contributed $1,000 to your TFSA in

2022, then $5,000 of unused space would roll over into 2023. This would then be added to the 2023 limit ($6,500) for a cumulative limit of $11,500.

What are the benefits of the TFSA?

You really can't go wrong with a TFSA. As a retirement account with tax-free earnings, a TFSA can give any Canadian's retirement planning a major boost.

- **Tax-free earnings.** Yes, it bears repeating — the CRA will not tax anything you earn in a TFSA. That means if you load your TFSA with Canada's best stocks, you can make some serious gains without paying the consequences.
- **Flexible spending**. You can withdraw money at any time for any purchase without paying an early withdrawal penalty. You also don't have to report TFSA withdrawals as income when you file your income taxes.
- **No withdrawal penalties.** Finally, unlike other retirement accounts, which penalize you for withdrawing money before a certain age, the TFSA has no withdrawal penalties, no matter how early you withdraw.

Who's eligible for a TFSA?

Canadians who are 18 years or older and have a valid Social Insurance Number (SIN) can open a TFSA.[2]

How much can you contribute?

For 2023, you can contribute up to $6,500 in your TFSA.[1]

However, if you've never opened a TFSA, and you're older than 18, you may have more contribution space.

Basically, the moment you turn 18 years old, you start accumulating contribution space in your TFSA—even if you've never opened one. For example, let's say Maury and Rachel were both 18 years old in 2009 (the year the CRA first launched the TFSA). Maury decides to open a TFSA when he's 18, and he contributes the maximum every year. By 2023, he would have contributed $88,000 — the maximum lifetime limit.

Now, let's say Rachel opens a TFSA in 2023. For Maury, he can contribute only $6,500 for that year. But for Rachel, it's $88,000 since she's never made a contribution before.

What happens if you over-contribute?

First, the CRA will notify you that you've over-contributed, giving you some time to fix the funds in your account. If you don't remove the excess, they'll hit you with a penalty: a 1% monthly charge on your above-contribution amount.

For example, if you contributed $9,000 in 2023 instead of $6,500, you'd pay 1% of $2,500 ($25) for every month you don't remove the extra $2,500.

Do earnings from investments affect your contribution space?

No. Your contribution space is only affected by the amount of money you contribute directly. Capital gains, interest, and dividends don't reduce how much space you have.

What happens if the TFSA holder dies?

TFSAs allow you to name a beneficiary on your account, which gives that person the account value (your contributions and any earnings) after you pass away. Once your beneficiary receives the money in your account, your TFSA provider will typically close your TFSA.

Note: It's very important to name a beneficiary on your Tax-Free Savings Account. Without one, your spouse or loved ones will have a hard time accessing the money in your account.

How to withdraw from a TFSA

You can withdraw from your TFSA at any time, for any reason, without paying taxes, penalties, or fees. Most TFSA providers will allow you to transfer funds from your retirement account into another bank account online, while others will let you withdraw money in person.

You can also recontribute money you've withdrawn from your TFSA, though you'll have to wait until the year after you've withdrawn your funds to put the same amount back in.

For example, let's say, in 2022, you had $81,500 in your TFSA (the maximum lifetime contribution space for that year). You decided to take out $15,000 to fund renovations on your home, which left $66,500 in your account.

In 2022, you wouldn't be able to recontribute the $15,000. But come 2023, your maximum contribution limit would be $21,500 with both the $6,000 annual TFSA limit and $15,000 you withdrew the year before.

Can you hold U.S. stocks in a TFSA?

Yes, you can buy and hold U.S. stocks in a TFSA. As long as the stock trades on a major U.S. stock exchange, such as the NYSE, you can likely hold it in your TFSA.

What's the difference between a TFSA and an RRSP?

As unique as TFSAs are, they're not the only tax-sheltered retirement account out there. TFSAs have a close cousin, the Registered Retirement Savings Plan (RRSP) which, depending on your situation, might be better for you. To help you decide between a [TFSA or RRSP](), here are some key differences.

1. More contribution space in an RRSP

For a [Registered Retirement Savings Plan](), you can contribute 18% of your previous year's income, up to $30,780 (for 2023).[3] Depending on how much you make, the contribution space in an RRSP could be significantly higher.

2. Withdrawals from RRSPs are taxed

Like the TFSA, the RRSP allows your contributions to grow tax-free. But unlike the TFSA, when you withdraw money from your RRSP, you'll pay income taxes for whatever you cash out.

Why do you pay income taxes? Well, it's because you contribute *pre-tax* dollars to an RRSP, meaning you haven't paid taxes on them yet, while the money you contribute to a TFSA is *after tax.* You've already paid income taxes on TFSA contributions, so you won't have to pay them again.

3. RRSP contributions are tax-deductible

In addition to tax-free earnings, you can deduct the amount you contribute to your RRSP from your gross annual income. This allows you to lower your taxable income, which helps you save on taxes. TFSAs, however, don't offer tax deductions on contributions.

4. RRSPs have less-flexible withdrawals

When you withdraw from an RRSP, you must report your withdrawal as income on your tax returns. In addition, if you withdraw before you turn 71, you'll pay an RRSP withholding tax, which can be between 10% and 31%, depending on your province and the amount you withdraw.

The only exception to the withholding tax rule is when you withdraw to pay for a house (up to $25,000) or to fund your education (up to $20,000).

5. RRSPs have an expiration date

Finally, your RRSP can't stay an RRSP forever. By December 31 of the year you turn 71, you must convert your RRSP into a Registered Retirement Income Fund (RRIF). TFSAs, however, don't have an expiry date.

In sum, a Tax-Free Savings Account is far more flexible. The RRSP has more contribution room but stricter withdrawal rules. At the end of the day, however, you shouldn't choose one at the expense of the other: a solid retirement plan will include both TFSAs and RRSPs.

How do you open a TFSA?

To open a TFSA, you need your Social Insurance Number (SIN), and you must be the legal age, either 18 or 19 years old.

- Territories and provinces with a minimum age of 18 include Alberta, Manitoba, Ontario, Prince Edward Island, Québec, and Saskatchewan.
- Territories and provinces with a minimum age of 19 include British Columbia, New Brunswick, Newfoundland, Nova Scotia, Northwest Territories, Nunavut, and Yukon.[4]

If you're the legal age and you have your SIN, then contact a valid TFSA issuer (a bank, credit union, insurance company, or other financial institution) and start the process.

Can you open more than one TFSA?

You can open as many TFSAs as you like.

But be careful — no matter how many TFSAs you hold, your contribution space never changes. Whether you have one TFSA or five, your annual and lifetime limits are always the same. So, if your annual TFSA limit is $6,000, and you have five TFSAs, you can contribute the $6,000 across all five but no more than the annual cap.

Should you open a Tax-Free Savings Account?

Definitely.

The tax advantages in a TFSA alone make these accounts worth your time and money. While you may need more than a TFSA to save for your retirement (an RRSP or non-registered retirement account), having one helps you avoid paying hefty taxes on gains, giving you more in savings towards your golden years.

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