TAX-FREE SAVINGS ACCOUNTS

Tax-free savings accounts are for the most part easier to understand and manage than RRSPs. While there is no tax deduction for making a TFSA contribution, there is no tax payable when the money is removed from an account. RRSP withdrawals, on the other hand, are fully taxable.

With TFSAs, it doesn't matter when money is withdrawn. The longer the money stays in a TFSA, the longer the income and capital gains can accumulate on a tax-free basis.

Even so, there are financial-planning considerations for TFSA investors when making contributions or withdrawals, and when your legal circumstances change. Here's what happens under five different scenarios:

1. You make a contribution.

An individual 18 or over is allowed to contribute up to $10,000 a year to a TFSA. Any unused amount becomes future contribution room in addition to the normal annual limit that becomes available on Jan. 1 of each year. If you've never contributed to a TFSA, and were at least 18 when the program began in 2009, you would have accumulated $41,000 in contribution room from past years. This is based on limits of $5,000 during each of the scheme's first four years, 2009-2012, and $5,500 for 2013 and 2014 and $10,000 for 2015. Contribution room can be carried forward indefinitely.

If you have put in more than your contribution room at any time, you must pay a penalty equal to 1% of the largest excess amount during the month in question. For example, assume you had $8,500 of contribution room available this year ($3,000 unused from previous years plus this year's additional $5,500). If that were the case and you contributed $10,000 this month, you would be offside to the tune of $1,500 -- and have to pay a penalty of $15. The penalty takes effect immediately. It would apply even if you withdrew the excess amount before the end of the month.

2. You make a withdrawal.

A TFSA withdrawal is not added to your income in the year of withdrawal. Hence there is no increase in your tax bracket and no impact on social benefits. Nor will money received from a TFSA create an Old Age Security clawback, reduce employment-insurance income, or affect the ability of lower-income people to claim the goods and services tax credit.

If you withdraw money from a TFSA, you are allowed to replace it later. Your cumulative contribution room remains intact. However, you have to wait until the following calendar year before recontributing to the extent of your withdrawal. (This assumes, of course, that you have no other room available because you have made the maximum contribution for the current year.)

3. Your marriage ends.

A TFSA can be transferred from one spouse to the other as part of a separation or divorce agreement, provided it is deemed by the Canada Revenue Agency to be a "qualified transfer." To qualify, the parties must be living apart at the time the assets are transferred. This must be done as a result of a court order or a separation agreement. Also, the money must be transferred directly from one TFSA account to another.

The person who gives up his or her TFSA assets retains his or her contribution room. However, he or she would not be able to replace the amount paid to their spouse; the transferred amount is not added back to his or her contribution room. The recipient has the advantage in this situation because the entire amount could be placed in their TFSA, even if the amount exceeded their contribution room. In fact, they would retain their existing unused contribution space.

On the other hand, if the money is withdrawn from the TFSA and then paid to the other spouse, the transferor can replace the paid-out amount the following calendar year, under the normal TFSA rules. This arrangement would be detrimental to the recipient, however, because he or she would be able to deposit this money into their TFSA only up to the limit of their unused contribution room.

4. You leave Canada.

If you become a non-resident of Canada, you can maintain your existing TFSA, and your investment income and withdrawals will remain exempt from Canadian tax. However, you cannot accrue new contribution room while you are a non-resident. TFSA income and/or withdrawals may be subject to taxation in your new country of residence. If you live in the United States, for example, income earned in a TFSA is taxable for U.S. purposes. Moreover, you may face onerous tax-reporting requirements because the Internal Revenue Service may consider TFSA income to be income from a foreign trust.

"Although there are Canadian tax benefits of retaining your TFSA, those benefits may be far outweighed by the foreign tax implications (like those of the United States) given the income-inclusion and information-reporting requirements of the foreign country,". Therefore, it may be beneficial to withdraw the full amount of your TFSA prior to departure from Canada, depending on the country in which you relocate."

If you emigrate from Canada but later return and become a Canadian resident again, you would not be subject to Canadian tax on the earnings of the TFSA. You would be allocated "a full annual increase in TFSA contribution room regardless of the date in which you immigrated to Canada. In other words, the annual limit is not prorated in the year of immigration."

5. You die.

A TFSA is not taxable upon death. However, because a deceased's assets are transferred to an estate account after death, income earned by TFSA assets after the date of death becomes taxable. If the successor account holder is a spouse, whether married or common law, the income can continue to grow tax-free within a TFSA in the spouse's name. A rollover of TFSA assets to the successor does not affect the successor's contribution room. Moreover, "an individual should consider designating their spouse as the successor holder in their TFSA, to avoid including the TFSA balance in assets subject to provincial probate."

TFSA assets that are bequeathed through a will can be received by the heir tax-free, although the future income on those assets will become taxable. However, if the recipient has unused TFSA contribution room, the inherited assets can be deposited into his or her account to the extent of that contribution room. Income earned from that amount can continue to be earned tax-free.

If the deceased TFSA holder does not have a spouse named as successor holder or designated beneficiary, the money passes to the deceased's estate, and is distributed under the terms of the will.