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Budget Analysis

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SAVING TAX-FREE

Too small a cap; too broad an application

BY ADVISOR GROUP

An initial reading of the federal budget last month left advisors with one strong long-term goal: to help their clients maximize their contribution room in the new tax-free savings account (TFSA) scheduled to launch in 2009.

In fact, on first pass, many investors were excited at the possibility of an additional, new tax-deferred investment vehicle. Advisors, however, realized that with the contribution room set to $5,000 a year, it would be a while before the TFSA would really add much to their business (or to their client's assets).

"The TFSA will have no material impact on our clients – at the start it will only save them $30 to $40 a year," explains Mark McNulty, a Markham, Ont.-based CFP and the youngest half of the father-son McNulty Team, a fee-only financial planning firm that caters to mature dentists and their families.

Nevertheless, for some clients it may be a boon. Cynthia Kett, a CFP at Stewart & Kett Financial Advisors, applauds the introduction of the new tax-free savings account. "It helps everybody," she says. "I think they were smart to do that for the dollar value that's involved."

In particular, the new account helps wealthier retirees who are withdrawing money from their RRSPs. "They can reinvest into this registered tax-free savings account and continue to tax-shelter that investment income."

Bruce Taylor, a senior financial advisor at Assante Capital Management, also lauds the new savings account as a useful tool for seniors, but agrees with Kett's assessment that the account favours wealthier clients most. "It helps those with money, because those that don't have the money won't be able to throw anything at it. It's something for the haves and not so much for those that are struggling to pay down debts and invest in RRSPs or other things."

Cash-rich retirees might choose to use the TFSA as their "fun" account, he adds, which would allow them to save for specific things like a vacation or a big purchase.

"The tax-shelter investment account is great news," adds Derek Burleton, associate vice-president at TD Economics.

Burleton says the fact that people can contribute without it affecting RRSP payments is important. "It provides another vehicle above and beyond RRSPs to save for retirement. We all know the power of compounding tax-free savings so it's a powerful new instrument."

In addition, during the early days of analyzing the TFSA, there isn't any consensus on how the account should be used in an overall financial plan.

Scott Plaskett, founder and CEO of IRONSHIELD Financial Planning in Toronto, says the new account would be useful for short-term planning since clients can remove money tax-free and then reinvest what they removed down the road. "We will discuss with clients whether or not it makes sense to use this from a long-term planning perspective, but it makes a lot of sense to redirect short-term investments into the tax-free savings account. It's a more tax-effective way of saving for the short term."

While clients can add to the TFSA from scratch, Christopher Hatherly, a Vancouver-based financial planner with IPC, suggests moving investments from a non-registered portfolio into the TFSA. "The non-registered portfolio is going to generate income that will be taxed. By moving it into the tax-free account, you won't have to pay on that going forward."

However, it's unclear if the government will allow investors to switch between accounts without getting penalized for withdrawing.

Wealthier clients will definitely want to use RRSPs over TFSAs for their retirement savings needs, says John McGuire, vice-president and product manager for registered products and pensions at BMO Nesbitt Burns. "For an individual whose income is large, they are going to want to get the tax deduction the RRSP represents."

Some younger people might not even be able to take advantage of the TFSA right now, since they don't have enough to save. But because the annual contribution amount accumulates – if you don't contribute $5,000 next year, you can add $10,000 the following year – the account could be a boon to an investor, or an inheritor, later in life.

In terms of estate planning, an unused TFSA could be a benefit. If your client has never used the account, he or she could rack up $150,000 worth of room. Then, if a loved one passes away and leaves your client $200,000, he or she could put it in the TFSA, where it will grow tax-free.

NET PROCEEDS FROM SAVING IN A TFSA RELATIVE TO OTHER SAVINGS VEHICLES

	TFSA	RRSP	Unregistered Savings
Pre-tax income	1,000	1,000	1,000
Tax (40% rate)	400	–	400
Net contribution[1]	600	1,000	600
Investment income (20 years at 5.5%)	1,151	1,918	707[2]
Gross proceeds (Net contribution + investment income)	1,751	2,918	1,307
Tax (40% rate)	–	1,167	–
Net proceeds	1,751	1,751	1,307
Net annual after-tax rate of return[3] (%)	5.5	5.5	4.0

[1] Forgone consumption (saving) is $600 in all cases. In the RRSP case, the person contributes $1,000 but receives a $400 reduction in tax, thereby sacrificing net consumption of $600.

[2] For unregistered saving case, tax rate on investment income is 28%, representing a weighted average tax rate on an investment portfolio comprised of 30% dividends, 30% capital gains and 40% interest.

[3] Measured in relation to forgone consumption of $600. Assumes annual nominal pretax rate of return is 5.5% invested for 20 years.

BUDGET TID-BITS

BY ADVISOR GROUP

Other Measures

Proposed changes will offer children of those contributing to Registered Education Savings Plans an additional 10 years to make use of the accumulated assets – proposed changes increase the amount of time an RESP may remain open from 25 years to 35 years. The proposal also extends the maximum contribution period by 10 years. Changes would apply to all existing and future RESPs, effective January 1, 2008.

RDSP

Advisors and investors are still awaiting news on an earlier budget initiative – the registered disability savings program.

In 2007 the Conservative government announced that it would implement the RDSP – a program for disabled Canadians that is similar to the registered education savings plan – but so far, there is no news on when the plan might begin.

Many advisors expected the plan to be introduced in early January, or February at the latest, but they now have no idea when the program might get off the ground.

Unfortunately, a spokesperson for the Department of Finance could not say when the RDSP will be available, but only that "2008 was always the date which the government is working with, and we are still on track with this measure." The spokesperson added that regulations are being drafted "at this moment."

JoAnne Hayes, a media representative for the Bank of Montreal, reveals that she's heard the plan will come into effect in December of this year.

Seniors

In addition to past changes that doubled the pension income amount to $2,000, increased the Age Credit amount by $1,000, increased the age limit for maturing RPPs and RRSPs from 69 to 71 and allowed pension income splitting for seniors and pensioners, the 2008 proposed budget would increase the amount that seniors could earn – from the current maximum exemption level of $500 to $3,500 – before their Guaranteed Income Supplement was clawed back.

Entrepreneurs

For businesses in the manufacturing or processing sectors, the budget proposes to implement three years of accelerated capital cost allowance (CCA) treatment that will allow business owners purchasing manufacturing and processing equipment between 2009 and 2011 to write off that equipment at an accelerated rate over the three-year period.

The budget also proposes to reduce the record-keeping requirements for automobile expense deductions.

Also, business owners with large numbers of employees will benefit from a reduction in penalties if late disbursing withholding payments to the government. Currently, an entrepreneur, late by an hour or more with a payment, is penalized 10%. Under the budget proposal, the penalties will be stratified so that it takes one week to reach that level.

Non-residents

Those buying Canadian property from non-residents, non-residents trying to sell their Canadian property and those who are exempt from paying Canadian income taxes under international tax treaties could benefit from streamlined cross-border tax-withholding and return-filing rules.