When the TFSA is Not Always Tax Free

Since its inception in 2009, the Tax-Free Savings Account (TFSA) has become a significant means to invest and grow funds for the future on a tax-free basis. With the 2022 TFSA dollar amount of $6,000, the total lifetime contribution limit now stands at $81,500 for those eligible. One of the reasons why the TFSA is seen as such a valuable tool is that holders generally will not be taxed on income or gains on investments held within the TFSA or upon TFSA withdrawals. However, despite the reference of being "tax free," did you know that there may be instances in which TFSA funds may still be subject to tax?* Here are three situations in which taxes may be due:

1. **Foreign investments held within a TFSA may be subject to tax.** If you hold foreign shares that pay dividends in the TFSA, they may be subject to a withholding tax on dividends paid. Within non-registered accounts, you would get a foreign tax credit for the amount of foreign taxes withheld; however, if dividends are paid to your TFSA, no foreign tax credit is available. For U.S. stocks, while there is an exemption from withholding tax under the Canada-U.S. tax treaty for U.S dividends paid to a Registered Retirement Savings Plan (RRSP) or Registered Retirement Income Fund (RRIF), this exemption does not apply for U.S. dividends paid to a TFSA.

Takeaway: Asset location can make a difference in the taxes you pay. Certain assets may be taxed differently based on where they are held (i.e., registered or non-registered investment accounts). Consider holding foreign dividend-paying stocks outside of a TFSA. Also, be aware that eligible Canadian dividend payments held within a TFSA will forego the dividend tax credit. As such, depending upon your circumstances, you may consider whether it makes sense to hold Canadian dividend-paying stocks in non-registered accounts.

2. **Beneficiaries may be subject to tax on the value of an appreciated TFSA.** While the TFSA can be transferred to a beneficiary on a tax-free basis at fair market value at the time of death, any gains that occur after the TFSA holder's death will generally be subject to tax. However, if the beneficiary is a spouse/common-law partner and if they are named as a "successor holder," the TFSA will continue to exist and both its value at the date of the original holder's death and any income earned after that date will continue to be sheltered from tax.

Takeaway: If the intended beneficiary is a spouse/common-law partner, consider the significance of designating them as a "successor holder." A successor holder can continue to operate the TFSA after a spouse's death relatively seamlessly, with assets remaining in the TFSA. If a spouse is, instead, named as a beneficiary, they would need to complete a transfer to their own TFSA and file certain forms with the CRA within specific time frames. Otherwise, any gains earned after death may not necessarily be tax sheltered.

3. **TFSA withdrawals that are recontributed within the year could be subject to tax.** Transfers between your own TFSA accounts may also be subject to tax. Remember that TFSA withdrawals will only reset contribution room in the following calendar year. If contribution room is not available, the withdrawal would be considered as an over-contribution and subject to a penalty tax of one percent per month until contribution room becomes available (or the over-contribution is removed). If you are considering a transfer between your own TFSA accounts, such as to consolidate accounts, the contribution room for any TFSA withdrawal will only reset in the following calendar year unless a "direct transfer" is completed by the financial institution.

Takeaway: With any TFSA contribution, ensure you have available contribution room. If you are uncertain, information is available on your Canada Revenue Agency (CRA) online account "My Account." You can also contact the CRA to request a "TFSA Room Statement" or "TFSA Transaction Summary" that details contribution and withdrawal information. Keep in mind that there may be a lag by the CRA in updating data at the start of the calendar year, so it may be worthwhile to keep good records. If you are consolidating TFSAs, consider having the financial institution complete a direct transfer to avoid potential penalty taxes.

*Note: This article is intended for Canadian residents who are not otherwise subject to U.S. income taxes as a U.S. permanent resident or U.S. citizen.

TFSA: DO YOU HAVE UNUSED CONTRIBUTION ROOM?

The 2022 TFSA dollar limit is $6,000. This brings the total lifetime contribution limit to $81,500 for those eligible. Do you have unused contribution room?

Year	Annual Dollar Amount	Cumulative Amount
2009 to 2012	$5,000	$20,000
2013 & 2014	$5,500	$31,000
2015	$10,000	$41,000
2016 to 2018	$5,500	$57,500
2019 to 2022	$6,000	$81,500