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E-BRIEF

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FISCAL AND TAX POLICY

TFSAs: Time for a Tune-Up

by

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- Tax-Free Savings Accounts (TFSAs) have experienced phenomenal growth since their inception 10 years ago. A review of the data shows that they are partly used as a tax-efficient vehicle for long-term capital accumulation, widely used for decumulation of retirement wealth in old age, and popular among younger Canadians to save for both near-term major purchases and achieve long-term saving purposes.
- The tax preference granted in TFSAs and RRSPs is essentially the same. Only the timing of taxation differs, which means that individually, taxpayers can profit from expected tax rate differences over their lives. The overall cost of TFSAs to governments is small in relation to the size of the assets concerned. In addition, to the extent that TFSAs are successful in encouraging new savings, and to the extent that there is some displacement of savings from RRSPs to TFSAs, new tax revenues that could be generated by hypothetically ending the TFSA program would be much lower than its current estimated fiscal cost.
- Building on these successes, this E-Brief proposes a few reforms to improve the operation of TFSAs and their ability to reach their objectives, including: i) making it possible to buy life annuities within a TFSA; ii) permitting the surviving spouse to utilize the unused TFSA contribution room of the deceased spouse, within limits; iii) creating a new Tax-Free Pension Account to help younger and low- to mid-income workers save for retirement on a tax-effective basis; and iv) resolving Canada–US tax issues.

Tax-Free Savings Accounts (TFSAs) first became available to Canadians 10 years ago. TFSAs enable Canadians to save their after-tax income on a "tax-paid" basis (Kesselman and Poschmann 2001), with no further taxes assessed on the investment income accumulating in the plan or upon withdrawal.

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After a decade in existence, there is now enough data and empirical analysis on TFSA utilization to enable a quick assessment of the extent to which the product is reaching its policy objectives, and how its evolution compares to preexisting Registered Retirement Saving Plans (RRSPs). This E-Brief will review the growth of TFSAs, identify patterns of utilization by age groups, and propose reforms to i) improve TFSAs ability to facilitate seniors' decumulation of retirement wealth, ii) improve the ability of low-to-mid-income workers to use TFSA-like savings as a long-term retirement accumulation product, and iii) resolve some Canada–US tax issues.

How TFSAs Work

Since 2009, Canadians adults have been eligible to contribute up to $5,000 annually to a TFSA with unused room being carried forward. The maximum contribution is indexed to inflation in $500 increments: as a result, the annual limit was increased to $5,500 in 2013, and to $6,000 in 2019. Including the 2015 odd year (the limit was raised to $10,000 for that single year), the cumulative TFSA contribution room for an individual who was at least 18 years old in 2009 has now reached $63,500.

Contrary to RRSP contributions, which reduce taxable income, TFSA contributions are drawn from after-tax income. Capital gains, interest and dividends earned in a TFSA, on the other hand, are never taxed. Withdrawals are tax-free (since in effect income taxes were already paid on the contributions) and do not induce reductions of income-tested government benefits.

In addition, and contrary to RRSPs, withdrawals are added back to an individual's cumulative contribution room at the beginning of the following year. Therefore, those who withdraw investment income that has accumulated in the plan can recontribute it in future years, thereby increasing their cumulative contribution room above the sum of annual legislated limits.

TFSA rules do not to permit taxpayers to recontribute an amount the same year that it is withdrawn – which is counter-intuitive. This has led to non-compliance issues over the years as taxpayers mistakenly replaced withdrawals with contributions in the same year, leading them at times to exceed their overall limit which is set at the start of each year.

Permissible TFSA investments are broadly similar to eligible arm's length RRSP investments.

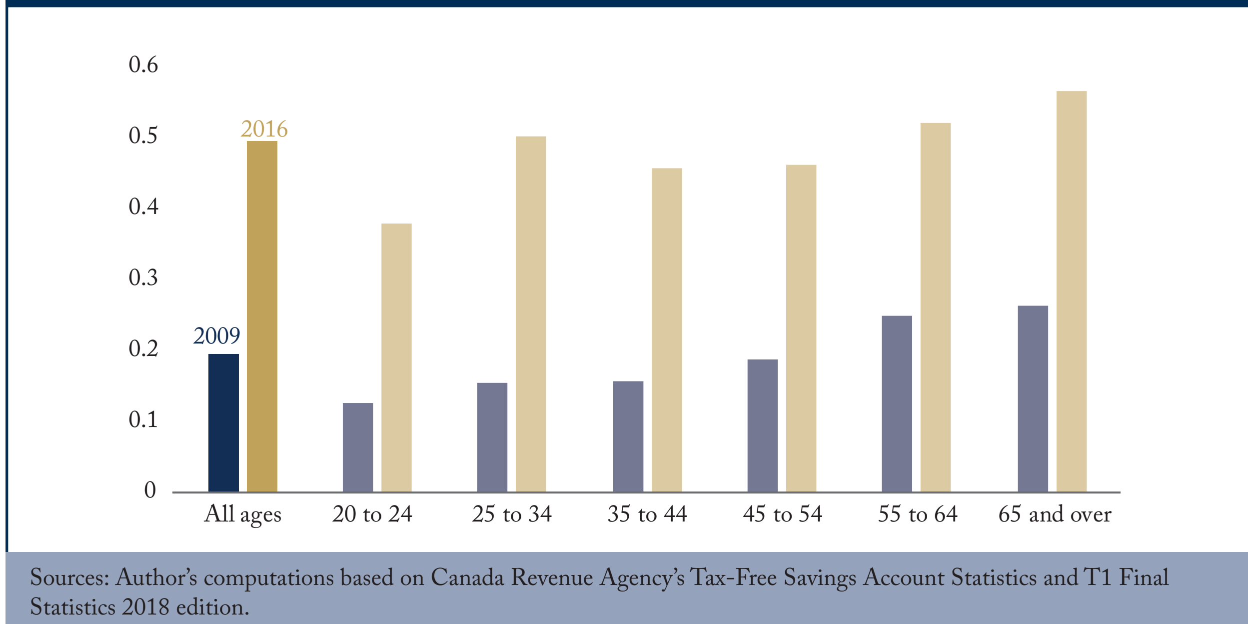
Policy Objective and Potential Uses

TFSAs were introduced to improve incentives to save by eliminating taxes on investment income. The 2008 budget envisaged a number of situations where TFSAs could incent greater savings:

- for major purchases such as a vehicle, a down payment on a new home, home renovations, or a child's wedding;
- to meet unforeseen needs;
- by low- and modest-income families because neither the income earned in a TFSA nor withdrawals from it affect eligibility for income-tested benefits and credits; and
- by seniors as a tax-effective tool to assist then in decumulating their retirement capital (Canada 2008).

In addition, the 2008 budget characterizes TFSAs as a complement to existing registered savings plans. It did not, however, envisage TFSAs as long-term retirement capital accumulation plans.

Figure 1: Share of All Taxfilers Holding a TFSA



Sources: Author's computations based on Canada Revenue Agency's Tax-Free Savings Account Statistics and T1 Final Statistics 2018 edition.

Phenomenal Growth

TFSAs experienced phenomenal growth in popularity since inception in 2009.

The fair-market value of all investments in TFSAs reached almost $233 billion by the end of 2016 – which is, by comparison, about 20 percent of all assets held in RRSPs, RRIFs and LIRAs[1] – after only eight years of existence. The value of contributions to TFSAs by persons younger than 65 years old in 2016 represented almost 4 percent of all gross wages and salaries earned in that year.

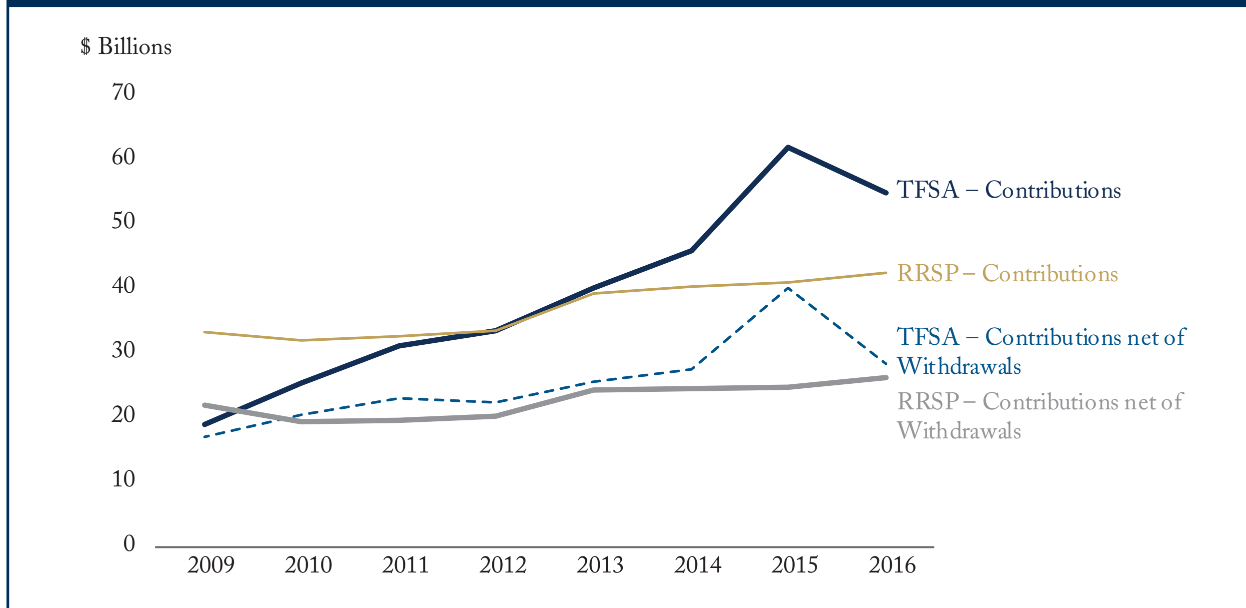
The growth in assets reflects the strong growth in the number and share of taxfilers holding a TFSA. The number of TFSA holders increased from 4.8 million in the first year to 13.5 million in 2016, with annual growth slowing down as the program matures. As a share of taxfilers, TFSA holders increased from 19 to 50 percent of all taxfilers, with the strongest growth in popularity occurring at younger ages. As of now, one-in-two 25- to 34-year-olds hold a TFSA, which is almost as many as the 65-and-over age category, the most popular age category, with 57 percent (Figure 1).

The immense popularity of TFSAs is evident when compared to RRSPs. In 2016, a total of $55 billion was contributed to TFSAs, compared to $42 billion to RRSPs. Annual TFSA contributions have exceeded those to RRSP's since 2013. The same is true of contributions net of withdrawals, where the annual value of net contributions to TFSAs also exceeds RRSPs' (Figure 2).

While the annual share of taxfilers making an RRSP contribution declined or remained stable in all age groups from 2009 to 2016, the share of taxfilers making a TFSA contribution progressed rapidly, especially at younger ages (Table 1). Note that the annual share of taxfilers making a contribution to either an RRSP or a TFSA

1 Registered Retirement Income Funds (RRIFs) and Locked-In Retirement Accounts (LIRAs). RRSPs have been around since 1957, while RRIFs were introduced in 1978.

Figure 2: TFSA and RRSP Total Contributions and Withdrawals, 2009 to 2016



Sources: Author's computations based on Canada Revenue Agency's Tax-Free Savings Account Statistics and T1 Final Statistics 2018 edition.

is lower than the share of taxfilers holding an account – see Figure 1 – since not all account holders contribute every year.

TFSA contributions per contributor also increased much faster than RRSP's during the period. On average, TFSA contributions increased at more than double the annual rate of increase of RRSP contributions. Among the 20- to 29-year-olds and 30- to 44-year-olds, TFSA contributions per contributor increased at an average annual rate of 5.2 and 5.8 percent, respectively, compared to 2.6 and 1.8 percent for RRSPs. The growth of TFSA contributions was even higher at older ages, reaching 8.4 percent per year on average for the 45- to 64-year-olds, and 9.6 percent for those 65 and older – again, more than double the rates of increase of RRSP contributions (Table 1).

TFSA Partly a Vehicle for Long-term Capital Accumulation

In 2016, contributors 20 to 29 years old contributed more than $4,600 on average to TFSAs, compared to about $3,500 for RRSP contributors. Contributions increase with age, with average RRSP contributions exceeding those to TFSAs by only a small margin for contributors older than 45 years old – overall, average annual contributions broken down by age are remarkably similar between TFSAs and RRSPs. Average annual contributions increase from more than $5,000 for 30 to 44 year-old contributors, to more than $7,000 for 45 to 59 year- olds, and to more than $9,000 for the 60 years and older.

Average annual contribution amounts are sizable, and follow the same age-pattern as RRSP contributions, which suggests that at least a portion of TFSA accumulation is long-term saving, possibly for retirement purposes. This raises the question: to what extent are TFSA contributions displacing contributions that otherwise would be made to an RRSP.

Table 1: Share of All Taxfilers Making a Contribution and Average Annual Contributions per Contributors, by Age Groups

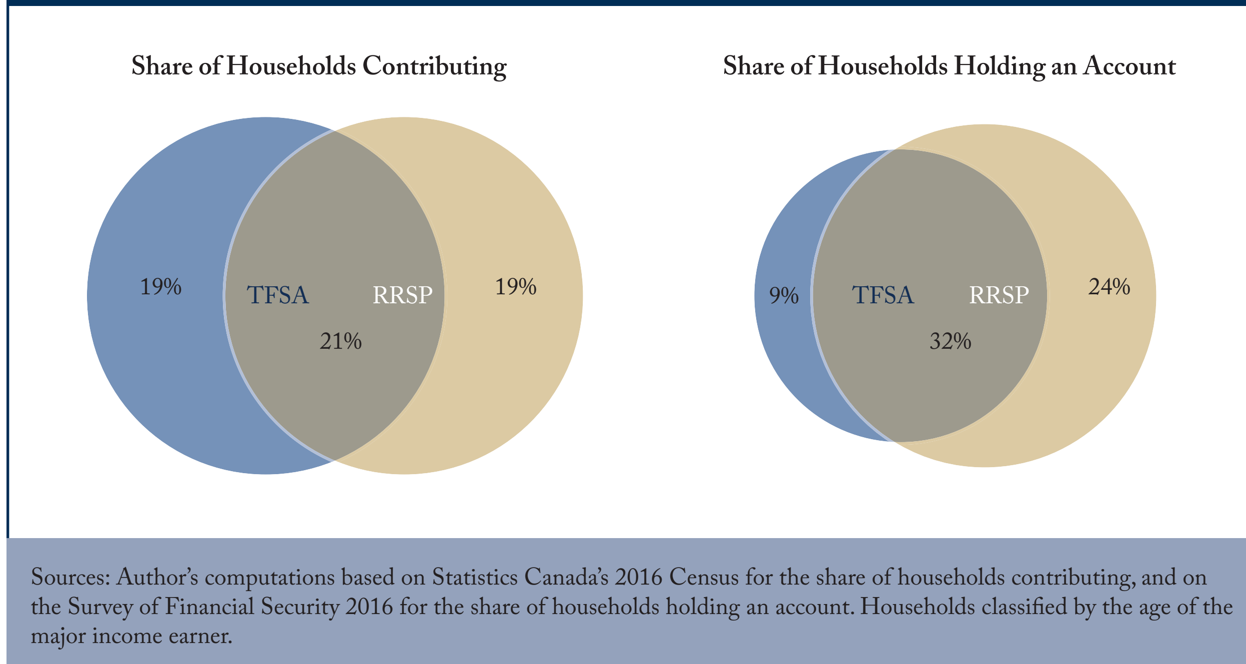
Share of All Taxfilers Making a Contribution									
		2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
20 to 29 years old	TFSA	0.13	0.16	0.20	0.22	0.25	0.27	0.29	0.29
	RRSP	0.17	0.19	0.16	0.15	0.15	0.14	0.14	0.14
30 to 44 years old	TFSA	0.14	0.16	0.19	0.20	0.22	0.24	0.27	0.27
	RRSP	0.33	0.33	0.32	0.32	0.32	0.31	0.31	0.31
45 to 59 years old	TFSA	0.19	0.20	0.22	0.23	0.24	0.26	0.28	0.27
	RRSP	0.36	0.36	0.35	0.35	0.35	0.35	0.35	0.35
60 years old and older	TFSA	0.25	0.28	0.29	0.29	0.31	0.32	0.33	0.31
	RRSP	0.10	0.09	0.10	0.11	0.11	0.11	0.11	0.11
Average Amounts Contributed (*dollars*)									
		2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
20 to 29 years old	TFSA	3,256	3,617	3,737	3,761	4,053	4,358	4,855	4,636
	RRSP	2,933	3,107	3,062	3,167	3,297	3,421	3,418	3,506
30 to 44 years old	TFSA	3,755	4,301	4,487	4,418	4,774	5,095	5,921	5,554
	RRSP	4,573	4,769	4,661	4,723	4,913	5,005	5,005	5,179
45 to 59 years old	TFSA	4,247	5,137	5,586	5,675	6,283	6,681	8,250	7,453
	RRSP	6,166	5,977	6,071	6,220	7,168	7,347	7,463	7,760
60 years old and older	TFSA	4,736	5,854	6,457	6,685	7,396	7,813	10,296	9,019
	RRSP	7,807	6,578	6,710	6,952	9,689	9,943	9,900	10,399

Sources: Author's computations based on Canada Revenue Agency's Tax-Free Savings Account Statistics and T1 Final Statistics 2018 edition.

About 60 percent of households younger than 71 contributed to either a TFSA or an RRSP in 2016. 40 percent contributed to a TFSA, of which more than half also contributed to an RRSP. There is thus considerable overlap between TFSA and RRSP contributors. This overlap is even more pronounced with respect to account holders – not all account holders make a contribution every year. More than three-quarters of households holding a TFSA – 32 percent of households – also owned an RRSP as of 2016. The degree of overlap is not surprising given that RRSPs have been in existence for a much longer period of time, but the fact that there is considerably less overlap with respect to contributions than account holding suggests the existence of at least some displacement of RRSP contributions in favour of TFSAs (Figure 3).

Berger et al. (2019) analyzed longitudinal data on Canadians from 2009 to 2015. They show that Canadians across different demographic groups appear to have diverted a significant portion of new savings away from RRSPs and into TFSAs since their introduction in 2009: every 1 percent increase in TFSA contributions reduced

Figure 3: TFSA and RRSP Participation Rates for Households Aged 15 to 70 Years Old, 2016



Sources: Author's computations based on Statistics Canada's 2016 Census for the share of households contributing, and on the Survey of Financial Security 2016 for the share of households holding an account. Households classified by the age of the major income earner.

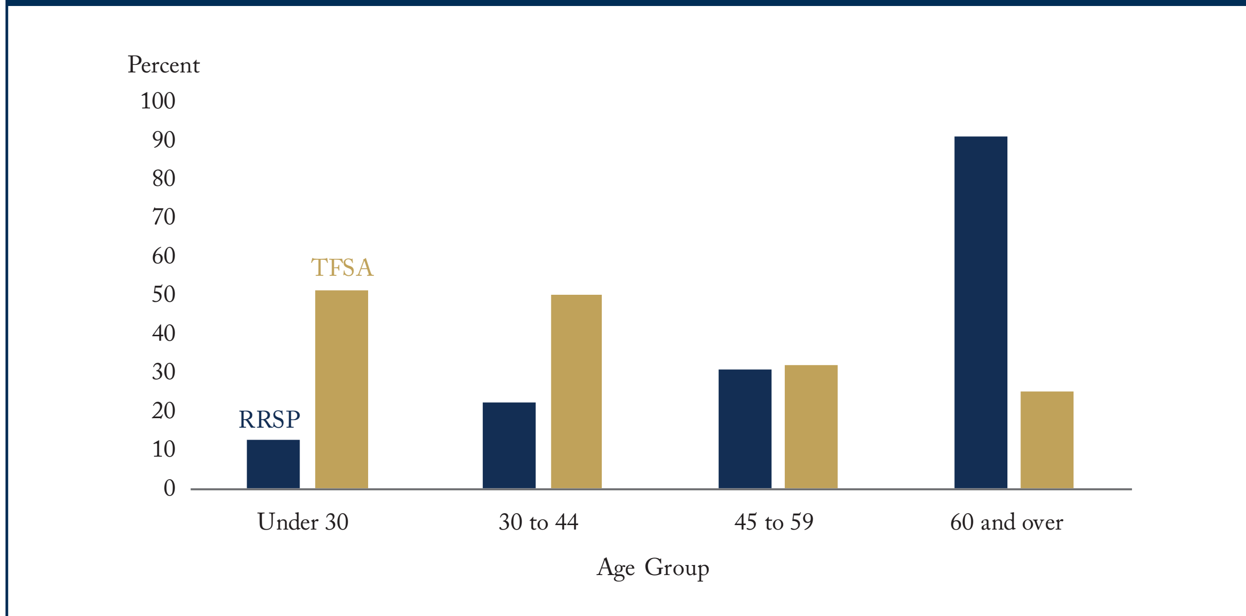
RRSP contributions by 0.4 percent. Therefore, about four out of 10 dollars of TFSA contributions since 2009 (net of withdrawals) might have been at the expense of unmade RRSP contributions.

Displacement of savings from RRSPs to TFSAs may also explain some of the outsized popularity of TFSAs compared to RRSPs at both younger and older ages. Berger et al. (2019) found that the displacement effect is stronger among younger age groups and older age groups.

TFSA savings may also be more prone to be withdrawn earlier than RRSP savings. From 2009 to 2016, aggregate TFSA withdrawals among those under 30 and those from 30 to 44 years old accounted for about half of aggregate contributions. In contrast, RRSP withdrawals accounted for only 13 and 22 percent of contributions, respectively, among this younger age group (Figure 4). Note that RRSP withdrawals do not include Home Buyers' Plan and Lifelong Learning Plan withdrawals, which may be substantial in these younger age groups. With this caveat in mind, the data suggest that younger people may be more prone to use TFSAs for major purchases that are typically bought earlier in one's working life, such as a down payment on a home, a first car, consumer durables, or a wedding.

Among those 45 to 59 years old, there are no material differences between TFSA and RRSP withdrawal rates – withdrawals account for about 30 percent of contributions for both (Figure 4). These are typically the prime ages for retirement savings, when income is higher (relative to the first half of working life) and the financial burdens of home acquisition and child support are lighter (Hamilton 2015). Average RRSP contribution rates as a percentage of income are also higher during this period of life (Laurin 2014). The fact that withdrawals rates are similar between TFSAs and RRSPs in this age group suggests that a sizable portion of pre-retirement contributions and investment income accumulating yearly in TFSAs will be available to Canadians as they move into retirement.

Figure 4: Withdrawals as a Percent of Contributions, 2009 to 2016



Sources: Author's computations based on Canada Revenue Agency's Tax-Free Savings Account Statistics and T1 Final Statistics 2018 edition. Aggregate withdrawals divided by aggregate contributions over the entire time period.

TFSAs Are Clearly a Preferred Vehicle for Capital Decumulation in Retirement

All evidence point to TFSAs being very popular among retired seniors. Each year, about a third of all taxfilers aged 60 and older contribute to a TFSA, and in 2016 contributed more than $9,000 on average (Table 1). Among households age 71 or older, 44 percent contributed to a TFSA in 2016, with a median contribution of more than $10,000.[2] Both the incidence of contributions and the amounts contributed are higher among seniors than any other age groups.

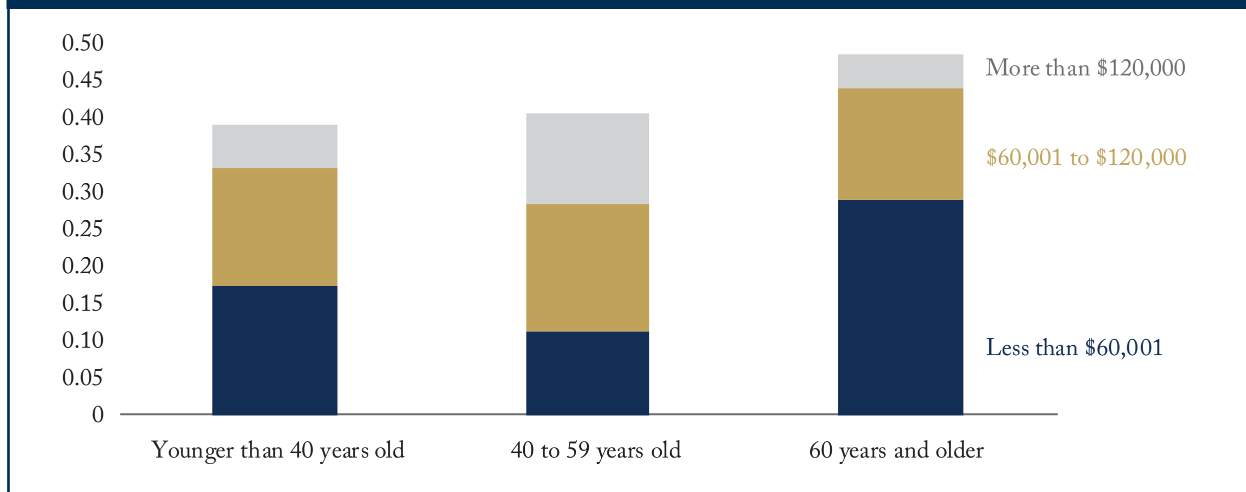
Households aged 60-plus are also disproportionately represented with respect to TFSA holdings. Almost half hold a TFSA, of which most have a household income of less than $60,000 and of which the majority held more than $25,000 in TFSA savings in 2016 – more than any younger age groups (Figure 5).

While RRSP withdrawals are naturally very high past 60 and into retirement ages, TFSA withdrawals amount to only a quarter of contributions – the lowest rate of withdrawal of all age groups (Figure 4). The 60-and-older withdrawal pattern is consistent with incentives for retired people in their capital decumulation phase to save unspent pension income in their TFSAs.

With interest rates so low, after-tax investment income on fixed-income assets suitable for capital investment in retirement may not even cover the increase in the cost of living. For seniors, TFSAs are a tax-effective tool to decumulate their retirement capital and insure against longevity risk.

2 Author's computations based on Statistics Canada's Census 2016.

Figure 5: Share of TFSA Holders Among Households by Age and Income Groups, 2016



Sources: Author's computations based on Statistics Canada's Survey of Financial Security, 2016.

Popular among Younger Canadians As Well

The popularity of TFSAs is evident among younger Canadians. Only 14 percent of taxfilers aged 20 to 29 years made an RRSP contribution in 2016, compared to 29 percent who made a TFSA contribution (Table 1).

Interestingly, younger individuals are drawn to TFSAs at a rate fairly similar to that of older individuals – in stark contrast with RRSP utilization. In 2016, the share of households younger than 40 years old and holding a TFSA was roughly the same as that of households aged 40 to 59 years old (Figure 5). Displacement of savings from RRSPs to TFSAs may explain some of the outsized popularity of TFSAs compared to RRSPs at younger age: Berger et al. (2019) found that the displacement effect is stronger among younger age groups and older age groups.

As the TFSA matures further, it will be interesting to see if it has a long-term impact on RRSP adoption. Younger individuals earn less than others on average, so the tax pre-paid feature of TFSAs is more tax-effective for many of them than the tax deferral of RRSPs. Those who start young on TFSAs (for instance, in a workplace group-TFSA) may opt to continue into TFSAs as they grow older and not switch to RRSPs for their tax-preferred investment option later in life. TFSA withdrawals do not affect eligibility for income-tested credits and benefits, such as the GIS, which may make them an attractive option for many young retirement savers (Stapleton and Shillington 2008, Laurin and Poschmann 2014).

Fiscal Cost Discussion

TFSA vs RRSP

TFSAs and RRSPs achieve essentially the same tax preference – i.e., no tax on the investment income. But they differ with respect to the timing of the income tax assessed on the underlying contributions. In TFSAs, the income contributed is taxed, then returns on the contributions are not. In RRSPs, income taxes on the contributions

Table 2: Illustrating the Mechanics of TFSAs Compared to RRSPs

	Same Tax rate (40%) on Labour Income Saved and on Retirement Income Withdrawal		Tax Rate on Labour Income Saved (40%) is Higher than on Retirement Income Withdrawal (30%)		Tax rate on Labour Income Saved (30%) is Lower than on Retirement Income Withdrawal (40%)	
	(*dollars*)					
	RRSP	TFSA	RRSP	TFSA	RRSP	TFSA
Amount Saved for Retirement	1,000	1,000	1,000	1,000	1,000	1,000
Taxes	0	(400)	0	(400)	0	(300)
Net amount Saved	1,000	600	1,000	600	1,000	700
Value after 20 Years (5% annual rate of return)	2,653	1,592	2,653	1,592	2,653	1,857
Taxes	(1,061)	0	(796)	0	(1,061)	0
Net income at Retirement	**1,592**	**1,592**	**1,857**	**1,592**	**1,592**	**1,857**
	RRSP and TFSA are equivalent		RRSP is superior		TFSA is superior	

Source: Excerpted from Laurin and Poschmann (2010), p. 2.

are deferred and due only when withdrawn.[3] So for the exact same investment earning the same rate of return, and the same tax rate at the times of contribution and withdrawal, both plans are conceptually equal from a tax perspective (Table 2).

But because tax rates will rarely be the same from the time of contribution to the time of withdrawal, individual contributors may take advantage of life-span arbitrage opportunities. Someone expecting an effective tax rate (inclusive of income-tested credits and benefits) in retirement higher than at contribution time would do well to lock in the lower tax rate in a TFSA. The reverse is also true. Someone expecting an effective tax rate in retirement lower than at contribution time would do well to lock in the lower tax rate in an RRSP.

Note that these tax arbitrage opportunities are based on individual expectations about the future, so they may not materialize. Even if some or most individual expectations do materialize, what matters for government fiscal costs is the sum of all of the individual realizations. And on aggregate, the effective tax-deferral rate on RRSP contributions is similar to the effective tax rate paid on the withdrawals.

Take estimated RRSP contributions and withdrawals in 2019. By deferring taxes on contributions, RRSP contributors saved on aggregate 36.9 percent of contributions. On all RRSP withdrawals (before age 65),

3 Conceptually, provided that tax rates on contributions and withdrawals are the same, the amount of taxes deferred is due when withdrawn with interest at the rate of return effectively earned within the plan (Golombek 2016).

Table 3: Effective Tax Rates on Aggregate RRSP and RPP Contributions and Withdrawals, 2019, Percent

	Taxes		Income-Tested Credits and Benefits		Total
	Federal	Provincial	Federal	Provincial	
RRSP Contributions	21.1	13.4	2.0	0.4	**36.9**
RRSP & RPP Contributions	21.9	15.0	2.0	0.5	**39.3**
RRSP Withdrawals (before age 65)	19.5	14.1	2.2	0.8	**36.5**
Pension Income & RRSP/RRIF Withdrawals	15.0	12.6	8.1	1.9	**37.6**

Sources: Author's calculations using Statistics Canada's SPSD/M. Author is solely responsible for results and interpretation.

taxpayers paid an effective tax rate of 36.5 percent. After adding to the mix tax-deferred contributions to workplace pension plans and pension income (which includes RRIFs), the difference widens but not by much: 39.3 percent on money going in compared to 37.6 percent on money coming out in retirement (Table 3).

Leaving inter-temporal tax-rate considerations aside, some argue that TFSAs are costlier to governments than RRSPs because in RRSPs abnormally high returns on investment are partly taxed on withdrawal while they are not in TFSAs.[4] This argument rests on the assumption that, for the government, the future value of the tax deferral on contributions should be discounted based on an assumed interest rate (cost of government financing) or an assumed risk-adjusted rate of return. So in an RRSP, governments profit from rates of return exceeding that discount rate. In TFSAs the entire return is untaxed.

This is the same as saying that in an RRSP, governments share in the risk and rewards with contributors. Governments can be rewarded from taking on the investment risk. But risk is not free. The downside is that governments can lose too if RRSP returns turn up lower than the assumed government discount rate. In TFSAs, losses do not affect tax revenues. All that is to say that higher expected government revenues on RRSP deferrals, compared to TFSAs, are normal compensation for sharing in investment risks with contributors. Governments could obtain the same compensation for risk if they invested the tax revenues on TFSA contributions in risky securities.

In fact, governments already do seek compensation for investment risks in public institutional funds such as the CPPIB, Caisse de dépôts, and AIMCO. These public investors benefit from scale and sophistication advantages enabling them to earn "above-normal returns"[5] not often available to typical RRSP investors. Looking at the

4 In particular, Alarie (2009) raises this point.

5 "Above-normal" returns in the economic literature refers to the economic rent earned above normal return to risk, and possibly unexpected windfalls. For more on this concept and application to the taxation of corporate profits, see Boadway and Tremblay (2016).

example in Table 2 above, where the tax rates are the same, if the government invests the $400 tax payment on the initial TFSA contribution, it could earn the same investment return that individual contributors could earn in an RRSP. After 20 years, the government would have the same $1,061 available to spend whether it comes from tax revenues on RRSP withdrawals, or from the future value of tax paid on the initial TFSA contribution and invested by the government. There is no reason to assume that individual RRSP investors are superior to public institutional investors at earning compensation for investment risk, or above-normal returns.

Conceptually, the tax preference granted in TFSAs and RRSPs is essentially the same. Only the timing of taxation differs, which means that individually, taxpayers can profit from expected tax rate differences through time. However, as one can see from Table 3, on aggregate they may not be very good at it.

Fiscal Cost of TFSAs

Finance Canada estimates the federal fiscal cost of TFSAs at $0.8 billion in 2016, on almost $233 billion of assets (Canada 2019). For 2018, the federal fiscal cost is projected at $1 billion. The cost to provinces is about half of the federal amount. Tax revenues forgone on the investment income earned in TFSAs is calculated by estimating how much of the total income earned in TFSAs is from interest, dividends or capital gains. The relatively low cost is likely the consequence of low returns – for example, TFSAs are popular among seniors whose suitable investment profile leads them to portfolios composed largely of deposits and fixed-income securities paying low interest rates.

The current low cost is also likely the consequence of the TFSA exempt tax base not having fully matured yet – it has been only 10 years of annual contribution room increases. As time goes by, a larger share of the older population will have accumulated greater room, greatly pushing up the average per person contribution room in the overall population. The Parliamentary Budget Officer (PBO) has projected the TFSA fiscal cost to increase ten-fold by 2080 (as a share of GDP), subject to considerable uncertainty (PBO 2015).

In addition, this cost estimate must be tempered by an important caveat. What if we were to estimate the cost of TFSAs by asking: what if TFSAs did not exist? We know that up to 40 percent of TFSA savings might otherwise be in RRSPs (Berger et al. 2019). In addition, the primary goal of the TFSA is to encourage new savings. To the extent that it is successful in incenting some savings that would otherwise not occur, cancelling the TFSA program would not result in new tax revenues on income from this incremental savings because those savings would not exist. TFSAs are only a cost to governments to the extent that they displace savings that would otherwise be invested in taxable accounts, or that they shift existing savings away from taxable accounts.[6] In actuality, allowing for behavioural incentives, were TFSAs not in existence the federal government's tax revenues in 2018 could be higher by only half or less of the $1 billion accounting cost.

Building on the Early Success: Time for a Tune-Up

TFSAs have experienced phenomenal growth since their inception 10 years ago. As expected, they are particularly popular among younger and older Canadians. Retired seniors make extensive use of TFSAs to tax-effectively

6 Lavecchia (2018) finds crowding out of taxable financial assets, mainly driven by lower balances of checking and savings accounts, at least in the first few years of TFSAs' existence. Lavecchia (2019) finds evidence that increases in TFSA balances reduce taxable financial assets, mainly fixed-income securities.

decumulate their retirement capital and self-insure against longevity risk. Also, evidence of RRSP displacement at younger ages and lower withdrawal rates in prime retirement savings years suggests that TFSAs are partly used as a tool for long-term capital accumulation.

Building on these early successes, TFSAs could be made even more useful for lower-income retirement savers and for seniors in their retirement years by making a few changes.

Facilitate Retirement Capital Decumulation

Many new retirees do not have a pension guaranteed for life. With the decline of private-sector defined-benefit pension plans, more and more seniors will rely on accumulated savings to provide for their retirement. But practically no one knows how long they will live. Those whose principal source of retirement income is not guaranteed for life need to protect against outliving their savings, which may translate into excess precautionary savings and a lower retirement lifestyle than may have been feasible (Ezra 2018).

Income Protection for Longevity in Retirement: The purchase of an annuity, which provides a guaranteed periodic payout for life or a fixed term, provides income protection for longevity in retirement (insurance against longevity risk). RRSP funds can be used to purchase annuities, thus preserving the tax preference on the interest income earned within the annuity contract. However, it is not possible to buy life annuities within a TFSA.[7]

This should change. More than 45,000 employers offer group RRSPs to their employees, with an increasing number also giving their employees the option to invest in an alternative group TFSA. Many of these plans involve employer contributions on top of employees'. Someone having funds accumulated in a TFSA (group or not) wanting to buy an annuity to insure against the risk of living a long life would have to withdraw the funds and purchase an annuity contract in which the interest portion of the payouts is taxable. This tax on the interest portion reduces the benefit of the annuity contract and makes the alternative of leaving the funds within the TFSA to self-insure against the risks of longevity – negating the benefits of longevity pooling – more tax-effective.

This cost distortion is unwelcome. It is unfair to those who will opt to save for retirement in a (group-)TFSA as opposed to a (group-)RRSP. It also unnecessarily limits retirees' options to purchase longevity insurance at a time when governments are concerned about the increasing cost pressures of providing long-term care to a rapidly aging population (Blomqvist and Busby 2012). The federal government should amend the legislation to make it possible to buy annuities within a TFSA. It should also modify the draft legislation creating advanced deferred life annuities (ALDAs) and variable payment life annuities (VPLAs) to make them both available for purchase within a TFSA.

Wasted TFSA Room at Death: Another limitation of TFSAs, compared to RRSPs, affects the ability for a surviving spouse to exploit the unused TFSA contribution room of the deceased at the time of death. When an RRSP holder with unutilized contribution room dies, the surviving spouse is provided with a period of time[8] to

7 A reviewer of an earlier version of this E-brief noted that tax law requires that TFSA assets be liquid and transferrable to a successor plan on demand. Fixed-term annuities generally satisfy this requirement, since there is no pooling of longevity risk in such products. Conversely, life annuities are not liquid, since such liquidity would allow consumers who learn of their reduced life expectancy after acquiring a life annuity to cash out to the detriment of other pool participants. Such liquidity would drive up the cost of life annuities, or make the product unviable from a risk management perspective.

8 In the year of death or during the first 60 days after the end of that year.

contribute into a spousal RRSP an amount up to the deceased spouse's unused RRSP room and claim a deduction against income in the deceased spouse's terminal return.[9] No spousal provisions exist for TFSAs, therefore no similar mechanism exists.

TFSA holders may name their spouses or common-law partner as successors or beneficiaries. Successors inherit the TFSA preserving all tax-exempt properties. Beneficiaries inherit the TFSA assets, which may be transferred to the TFSA of the surviving spouse or common-law partner without reducing the survivor's existing room. Any unused TFSA contribution room at death is lost.

A terminally ill individual wanting fill up his or her unused TFSA room to the profit of his or her spouse after death can do so before death by liquidating other assets and investing the proceeds into his or her TFSA. This financial planning, however, is often very challenging for spouses to deal with in these emotionally difficult circumstances.

In addition, sometimes death is sudden, leaving no time for financial preparation. In other cases, lower- to middle-income taxpayers may be unable to fully fund their TFSAs due to cost of care or other financial commitments. However, on death of the spouse there may be life insurance or other sources of capital that would permit the surviving spouse to top-up TFSA contributions and benefit from tax-free growth in the future.

Permitting the surviving spouse, who is the successor or the beneficiary of the deceased's TFSA, to utilize the unused TFSA contribution room of the deceased spouse would encourage more savings at a critical time for spouses, helping them to financially prepare for living longer than they may anticipate and facing long-term care costs. Just as for RRSPs, reasonable limits could apply on the amounts of, and the period of time within which, contributions could be made.

Expanding Long-Term Retirement Capital Accumulation Possibilities

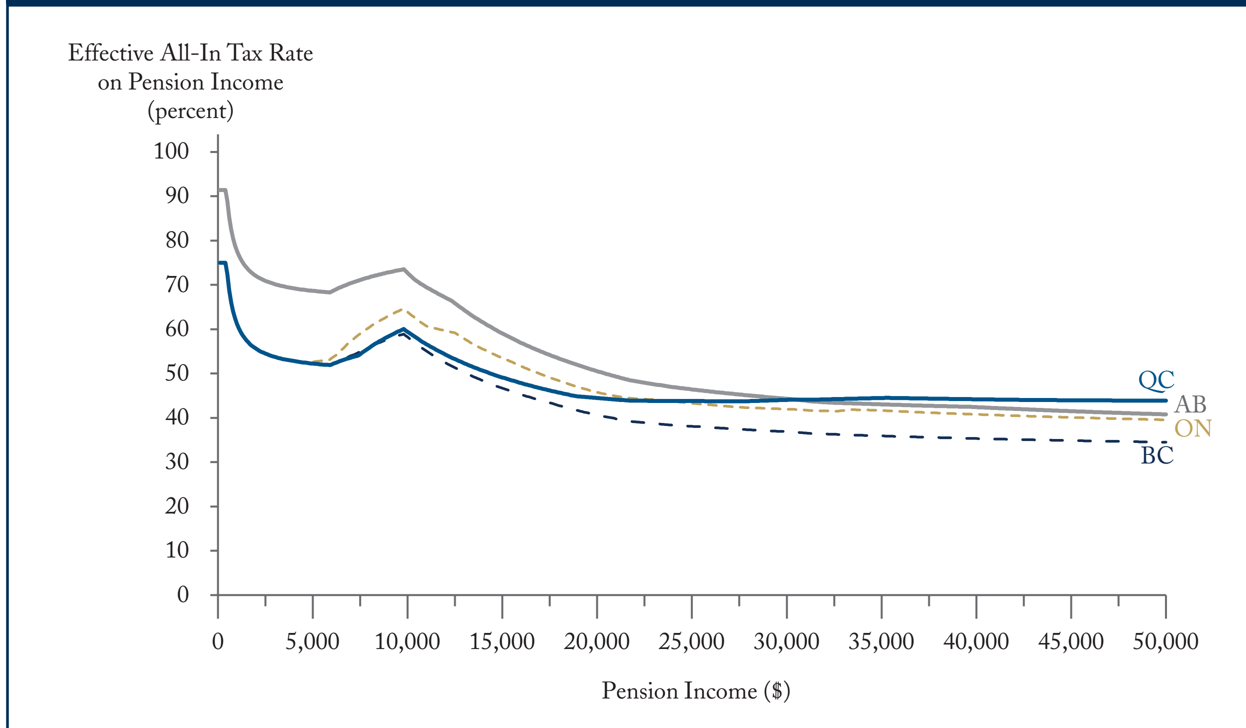
TFSA withdrawals do not affect entitlement to income-tested benefits, which means that lower-income workers can use TFSAs for retirement income purposes without reducing their entitlement to Guaranteed Income Supplement (GIS) benefits (and other fiscal benefits). For low-income retirees, effective tax rates on their taxable pension income are very high: the combined effect of income taxes and clawbacks of federal and provincial income-tested benefits such as the federal GIS and associated provincial supplements means that new retirees can expect effective tax rates greater than 50 percent on up to about $15,000 of pension income earned in excess of average Q/CPP benefits (Figure 6).

Therefore, for many low- to mid-income workers, their effective tax rate on plan contributions is lower than their expected effective tax rate on pension income and withdrawals. If the objective is to minimize taxes over a lifetime, then one would be better off saving for retirement in the tax-preferred form likely to result in the lowest lifetime taxes. Based on income levels and a multitude of individual circumstances, clearly many low-income individuals would be better off in TFSAs than RRSPs for their retirement saving.

Pierlot and Laurin (2012) simulate various lifetime after-tax outcomes of retirement savings depending on whether savings occur in RRSPs or in TFSAs. Their calculations are based on reasonable assumptions regarding individual lifetime savings, earnings and desired income in retirement, and assume no change to tax laws. On

9 As one reviewer of an earlier version of this E-Brief noted, the surviving spouse must be under age 71 to benefit from this measure, restricting its scope.

Figure 6: Effective Tax Rate on Pension Income in Excess of Average Q/CPP for New Beneficiaries (age 65), 2018



Sources: Author's calculations using Statistics Canada's SPSD/M. Computations are for a single GIS-eligible senior. Average Q/CPP = $8,022. Author is solely responsible for results and interpretation.

average in 2012, 30-year-old single individuals earning $33,300 and retiring at 65 could achieve tax savings equivalent to 23 percent of gross accumulated assets by investing in a TFSA (as opposed to a RRSP). For mid-income single earners ($50,000 earnings), average tax savings were estimated at about 10 percent of gross accumulated assets.

TFSAs are funded with income that has already been subject to personal taxation, and no taxes are payable on withdrawals. For this reason, these plans are often dubbed "tax-prepaid." To facilitate the use of tax-prepaid vehicles for retirement capital accumulation, Pierlot and Laurin (2012) proposed the creation of a dedicated new Tax-Free Pension Account (TFPA) to complement the use of TFSAs. Analogous to the TFSA, TFPAs would allow for the same tax-free accumulations and withdrawals. Because of its pension nature, this new account would be entirely separate from TFSAs. TFPAs would be available to everyone although they would be particularly geared to the needs of low- to mid-income workers.

Ideally, workplace capital accumulation plans – such as individual DC, multiemployer, pooled plans, and group-TFSAs – would offer a TFPA option. This would effectively provide a tax-prepaid option for long-term retirement capital accumulation, benefiting from the same creditor protection as pensions and RRSPs. Governments worried about abuse could impose penalties on early redemptions of funds.

Bearing in mind that the TFPA would be primarily intended for sheltering employment income saved for retirement purposes, the TFPA contribution limit could be integrated with that of RRSPs and registered pension

plans (as originally proposed in Kesselman and Poschmann 2001).[10] Effectively, there would be only one tax-preferred contribution limit for retirement saving accounts, encompassing both tax-deferred contributions (to registered pension plans and RRSPs) and tax-prepaid contributions to TFPAs.

Paralleling RRSPs and pension plans, withdrawals from TFPAs would result in lost contribution room. To help older and younger workers to have the same opportunity to participate in a TFPA, unused tax-deferred contribution room would become available for TFPA contributions.[11]

The TFPA would be in addition to TFSAs, and since it would share its maximum contribution limit with the existing tax deferral regime, TFPA would not create any additional room to save on a tax-preferred basis. It would, however, expand long-term retirement capital accumulation possibilities beyond TFSAs for low- to mid-income workers, and would possibly mitigate employers' reluctance to contribute into group-TFSAs. Better financial education by governments and employers would help improve individual workers' decisions (Boyer et al. 2019).

Canada–US Tax Issues

Due to shared history and proximity with the United States, thousands of Canadians are dual citizens of Canada and the United States, or green card holders having to file US taxes. All US citizens and tax residents living in Canada must file US taxes. Under the Canada-US Tax Treaty, RRSP holders may defer taxation of income earned in the plan in the US until withdrawals are made, mirroring the Canadian tax treatment. But no such provisions exist with respect to TFSAs, which means that US citizens and tax residents must report TFSA investment income as part of their US tax filing and possibly pay taxes on it. This has the effect of discouraging Canadian tax residents who are also US citizens and tax residents, and dual citizens, from holding a TFSA.

This is primarily a US tax issue, since the US, unlike Canada, taxes individuals based on their citizenship as opposed to their residency. The US is reportedly the only country to levy lifelong citizenship-based taxation. The creation of a TFPA, which would be a retirement savings account similar to US Roth IRAs, may provide new grounds for Canadian officials to obtain tax treaty reciprocity for the TFPA/TFSA.

Another issue relates to US withholding taxes on dividend payments to a TFSA. Generally, Canada and the US will withhold a tax on dividends arising in their respective country and paid to a resident of the other country. An exemption to withholding taxes exists in the Canada–US tax treaty for dividends earned within registered plans administered to provide pension, retirement, or employee benefits, such as an RRSP.[12] No such exemption exists for TFSAs. Again, the creation of a TFPA may help negotiate a solution to this issue.

While this may be easier said than done, the federal government should make every effort possible to resolve these two US tax irritants.

10 Laurin and Poschmann (2010) and Kesselman (2015) make a similar proposal for an integrated TFSA/RRSP limit. In particular, Kesselman (2015) proposed to grant additional TFSA room to individuals with unused RRSP room.

11 In addition, perhaps for a limited period of time after the TFPA implementation, individuals wishing to cash out all or part of their RRSPs and invest the after-tax proceeds in a TFPA could be allowed to do so without losing the RRSP room on the withdrawals.

12 See TaxTips.ca: TFSA Taxes; accessed December 2019.

Conclusion

Tax-Free Savings Accounts have experienced phenomenal growth since their inception 10 years ago. A review of the data shows that they are partly used as a tax-efficient vehicle for long-term capital accumulation, widely used for decumulation of retirement wealth in old age, and very popular among younger Canadians to save for both near-term major purchases and achieve long-term saving purposes.

Nevertheless, further improvements are recommended, including:

(i) Making it possible to buy life annuities within a TFSA – including the proposed VPLAs and ALDAs – would encourage individual protection against longevity at a time when governments are concerned about the increasing cost pressures of providing long-term care to a rapidly aging population.

(ii) Resolving Canada–US tax issues would improve the operation of TFSAs.

(iii) Permitting a surviving spouse to utilize the unused TFSA contribution room of the deceased spouse, within limits, would recognize the difficult circumstances faced by terminally ill individuals and their families, as well as encourage more savings at a critical time.

(iv) Creating a new Tax-Free Pension Account may induce a greater number of younger and low- to mid-income workers to save for retirement on a tax-effective basis.

These reforms, building on the early successes of TFSAs, would encourage the continued growth of TFSAs and their ability to reach their objectives.

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