TFSAs and the Value of Compounding

Tax-Free Savings Account: Understand the potential for your long-term retirement plans

By David Harris, CFP

Investment Advisor*

Over the past 10 years, advisors and financial planners across the country have been pushing clients to open and invest in one of the greatest tax-strategies Canadians have at their disposal, the Tax-Free Savings Account ("TFSA"). Many have followed this advice, but recent studies have shown that 39% of Canadians plan to use their TFSA as an emergency fund.[1] While the TFSA is well suited for this purpose, we want to outline why you should consider including the TFSA as a larger part of your financial picture.

About the TFSA

The TFSA program began in 2009, establishing a way to set money aside tax-free throughout an individual's lifetime. Contribution room is accumulated each year for individuals 18 and older, who have a valid social insurance number. Unlike an RRSP, contributions to a TFSA are not deductible for income tax purposes. However, any amount contributed, as well as any income earned in the account (for example, investment income and capital gains) is tax-free, even when it is withdrawn!

* Cumberland Private Wealth Management Inc.

To illustrate the TFSA's long-term potential, let's look at a quick case study.

John is a 50-year-old entrepreneur, who has built up a sizable RRSP. However, John has never opened a TFSA, despite having more than $200,000 in a personal savings account. John has accumulated TFSA contribution room each year since 2009, giving him a lifetime contribution limit of $63,500. We'll assume that John made a full $63,500 contribution in January 2019 and contributes $6,000 (the 2019 contribution limit) to his TFSA each year until turning 80.

As you can see in the chart on the right, the compounding potential of the TFSA is remarkable, with the account growing to almost $1.6 million by age 90. Another point to note is that John's family could double this tax-free amount if his spouse makes these same savings in her own TFSA.

TFSA Projection - 6% p.a. Net Return

Age	Year	Contribution	End of Year Value
50	1	$63,500.00	$67,310.00
51	2	$6,000.00	$77,708.60
52	3	$6,000.00	$88,731.12
53	4	$6,000.00	$100,414.98
54	5	$6,000.00	$112,799.88
55	6	$6,000.00	$125,927.87
56	7	$6,000.00	$139,843.55
57	8	$6,000.00	$154,594.16
58	9	$6,000.00	$170,229.81
59	10	$6,000.00	$186,803.60
60	11	$6,000.00	$204,371.81
61	12	$6,000.00	$222,994.12
62	13	$6,000.00	$242,733.77
63	14	$6,000.00	$263,657.80
64	15	$6,000.00	$285,837.26
65	16	$6,000.00	$309,347.50
66	17	$6,000.00	$334,268.35
67	18	$6,000.00	$360,684.45
68	19	$6,000.00	$388,685.52
69	20	$6,000.00	$418,366.65
70	21	$6,000.00	$449,828.65
71	22	$6,000.00	$483,178.37
72	23	$6,000.00	$518,529.07
73	24	$6,000.00	$556,000.81
74	25	$6,000.00	$595,720.86
75	26	$6,000.00	$637,824.11
76	27	$6,000.00	$682,453.56
77	28	$6,000.00	$729,760.77
78	29	$6,000.00	$779,906.42
79	30	$6,000.00	$833,060.81
80	31	$6,000.00	$889,404.46
81	32		$942,768.72
82	33		$999,334.85
83	34		$1,059,294.94
84	35		$1,122,852.63
85	36		$1,190,223.79
86	37		$1,261,637.22
87	38		$1,337,335.45
88	39		$1,417,575.58
89	40		$1,502,630.11
90	41		**$1,592,787.92**

Estate and Retirement Planning Benefits

The immediate benefit of having such a large TFSA would be the ability to earn tax-free growth on the account (imagine earning tax-free growth on $1.6 million!). However, there are several estate and retirement planning benefits as well:

1) **Elect a beneficiary to avoid probate.** If a beneficiary is designated for your TFSA, the value of the account at the time of death can be paid to the beneficiary tax-free. Importantly, the TFSA would not pass through your estate, meaning no probate would be payable on death. If at age 90, John (in the example above) passed away while a resident of Ontario, his estate could save $23,500 in probate fees if the $1.6 million were in a TFSA as opposed to a non-registered account.[2]

2) **Elect your spouse as a successor holder so they can inherit your TFSA at the time of your death.** A successor holder is a type of beneficiary designation available for a TFSA. If your spouse is designated as a successor holder, any income earned in a TFSA after your death remains tax-free and can be invested in the spouse's TFSA as well! Without a successor holder designation, CRA legislation requires that income earned in your TFSA after death be reported for tax purposes.

3) Income Splitting Benefits. You can split income with your spouse or children above the age of 18 by gifting them funds to use for their annual TFSA contributions. As we saw in the case-study, these annual contributions can make a substantial difference in a person's future net worth. In the case of children, this income splitting strategy could provide a tax-efficient nest egg for a down payment on a new home. Regardless of how the funds are used, the TFSA provides another potential vehicle to transfer assets to family members and lets them compound these funds tax-free as well.

Your TFSA can make a significant impact on your retirement if used properly and the benefits of avoiding probate, ensuring proper account succession and income splitting show some of its potential in addition to the TFSA' s tax-free compounding. If you have yet to fully contribute to your TFSA in 2019, we encourage you to speak with your Portfolio Manager.

1. https://www.moneysense.ca/save/investing/tfsa/what-canadians-know-about-tfsas-and-how-they-use-them/
2. Probate fees in Ontario are $250 for the first $50,000 of your estate and $15 for each additional $1,000 with no upper limit. A non-registered account of $1,600,000 would face probate fees of $23,500. (250 + ($1,550,000/$1,000 * $15) = $23,500).