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New Tax-Free First Home Savings Account provides flexibility

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Canadians have been waiting a long time for a budget announcement that might actually move the needle on financial planning opportunities for a good portion of the country. The introduction of the new Tax-Free First Home Savings Account in the federal budget on Thursday is a step in that direction.

FHSAs, which the government says will become available at some point next year, will be sort of like a combination of RRSPs, TFSAs and the Home Buyer's Plan – on steroids.

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Here's what I mean: an FHSA will be like an RRSP in that you will be able to contribute a certain amount each year, and you'll get a tax deduction for each contribution. It will be like a TFSA because most withdrawals you make from an FHSA will be tax-free. And it will be like the HBP because it will allow you to use assets in the plan to help pay for a home purchase.

When it comes to saving for a home, an FHSA can outperform those other plans. Let's take a closer look.

How it works

To set up an FHSA, you have to be a resident of Canada and at least 18 years old. (The budget made no mention of an upper age limit.) And you'll have to be able to show that you didn't live in a home you owned in the year you opened the account, or the prior four years. When you open an FHSA you'll be able to contribute up to $8,000 each year, to a maximum of $40,000 in your lifetime.

If you skip a year of contributions, you won't be allowed to contribute $16,000 the following year to make up for lost time. The most you'll be able to contribute in any year is $8,000.

The money in the plan will be able to grow tax-free and will then be available for withdrawal tax-free, provided you're making the withdrawal to buy a home. Withdrawals for other purposes will be

taxable. You'll only be able to make withdrawals for one property in your lifetime. That is, you wouldn't be allowed to use FHSAs to save for more than one home, and once you'd made a withdrawal from an FHSA you'd have to close the account within one year and you wouldn't be able to open another one.

You'll be able to have more than one FHSA, but the total amount you contribute to all of your FHSAs won't be allowed to exceed your annual and lifetime limits.

How to benefit

It's a no-brainer to open an FHSA if you've never owned a home before. You'll get a tax deduction for the amount contributed, which will save you money immediately, and you might even get a tax refund. You could then use that refund for other things, including paying down debt, contributing to your RRSP or TFSA, or making another contribution to your FHSA.

You'll have 15 years from the time you open an FHSA to buy a home. But what if you don't end up buying a place? Good news: You'll be able to transfer the funds from your FHSA to an RRSP or RRIF. There will be no tax to pay when making this transfer, and you won't need RRSP contribution room. In other words, this transfer could be made over and above your usual RRSP contributions. The amount would then be taxed when you withdraw the funds from your RRSP or RRIF later, as with any RRSP or RRIF withdrawals. You can think of an FHSA as additional RRSP contribution room, even if you don't buy a home.

If you don't have the funds to contribute to an FHSA, you'll be able to transfer funds from your RRSP into your FHSA – subject to the usual annual and lifetime limits. The advantage of this over, say, using the HBP to tap RRSP funds for a home purchase is that you could make a tax-free withdrawal from the FHSA without having to repay the funds over time.

The rules won't allow you to use both the HBP and an FHSA for the same home purchase, but the FHSA will generally make more sense, since it will allow you to save and withdraw more. The only advantage to the HBP would be that you could end up with more savings in retirement, because you'd be required to repay the funds withdrawn.

We haven't seen draft legislation yet for FHSAs, so we don't know whether you'll be able to contribute to the FHSA and make a withdrawal in the same year. It would be helpful if you could. Then you could contribute $8,000, get a tax deduction for this amount, and withdraw the funds shortly after to buy a home. The tax savings could pay for legal fees and other closing costs.

I'll write more about this when the government releases more information, which should be soon.

Tim Cestnick, FCPA, FCA, CPA(IL), CFP, TEP, is an author, and co-founder and CEO of Our Family Office Inc.
He can be reached at tim@ourfamilyoffice.ca