Tax-Free First Home Savings Account – How Does It Work?

Introduction

Budget 2022 announced a new savings account for first time home buyers – the Tax-Free Home Savings Account (FHSA). This is one of several initiatives designed to make housing more affordable for younger Canadians. In effect, the FHSA combines the best features of an RRSP (tax-deductible contributions and tax deferred income) and a TFSA (tax-free withdrawals for a qualifying first home purchase). It is an alternative to the Home Buyers' Plan (HBP) which allows for the tax-free withdrawal of up to $35,000 from an RRSP to purchase a qualifying first home. However, unlike the HBP, there is no requirement to repay withdrawals from a FHSA.

Draft legislation has now been released which includes details on the requirements to open a FHSA and the tax treatment of the FHSA and plan holder. As well, the Department of Finance released a background document which highlights the key tax attributes and administration requirements for these plans (https://www.canada.ca/en/department-finance/news/2022/08/design-of-the-tax-free-first-home-savings-account.html#:~:text=Backgrounder,on%20a%20tax%2Dfree%20basis.).

Opening and closing accounts

The following are the key requirements to open and maintain a FHSA:

- The individual must be a resident of Canada and at least 18 years of age; and
- The individual must not have owned a home in which they lived at any time during the part of the calendar year before the account is opened or at any time in the preceding four calendar years.

As is the case with RRSPs and TFSAs, each qualifying family member can own a FHSA and presumably use their respective plans to jointly purchase a first home provided they plan to use the home as their principal place of residence.

The FHSA would cease to be an FHSA, and the individual would not be permitted to open an FHSA, after December 31 the year in which the earliest of:

- The fifteenth anniversary of the individual first opening an FHSA; or
- The individual turns 71 years old.

Note that any savings (including accumulated income) not used to purchase a qualifying home may be transferred on a tax-free basis into an RRSP or RRIF. Otherwise, the funds in a FHSA will need to be withdrawn on a taxable basis.

Qualified investments

An FHSA will be permitted to hold the same qualified investments as those permitted for a TFSA. In addition, the prohibited investment rules and non-qualified investment rules applicable to other registered plans will apply.

Contributions

The lifetime limit on contributions is $40,000, with an annual contribution limit of $8,000. The full annual limit would be available starting in 2023. **Unlike RRSPs**, contributions made within the first 60 days of a given calendar year will not be eligible for deduction in the previous tax year.

An individual may carry forward unused portions of their annual contribution limit up to a maximum of $8,000. For example, an individual contributing $5,000 to an FHSA in 2023 would be allowed to contribute $11,000 in 2024 (i.e., $8,000 plus the remaining $3,000 from 2023). **Carry-forward amounts would only start accumulating after an individual opens an FHSA for the first time**.

Like an RRSP, an individual will not be required to claim a deduction for the tax year in which a contribution is made. Such amounts can be carried forward indefinitely and deducted in a later tax year.

Taxation of withdrawals

In order for an FHSA withdrawal to be a qualifying (i.e., non-taxable) withdrawal, certain conditions must be met as follows:

- The individual must be a first-time home buyer at the time a withdrawal is made.
- The individual must also have a written agreement to buy or build a qualifying home before October 1 of the year following the year of withdrawal and intend to occupy the qualifying home as their principal place of residence within one year after buying or building it.

A qualifying home is a housing unit located in Canada and includes a share in a co-operative housing corporation that entitles the taxpayer to possess and have an equity interest in a housing unit located in Canada.

Withdrawals that are not qualifying withdrawals will be included in the income of the plan holder. Withholding tax will apply to non-qualifying withdrawals, consistent with the treatment applicable to taxable RRSP withdrawals.

Non-qualifying withdrawals would not re-instate either the individual's annual contribution limit or the lifetime contribution limit.

Transfers

An individual may transfer funds from an FHSA to another FHSA, an RRSP or a RRIF on a tax-free basis. These transfers will not reduce, or be limited by, an individual's available RRSP contribution room. However, these transfers will not reinstate an individual's FHSA lifetime contribution limit.

Individuals will also be allowed to transfer funds from an RRSP to an FHSA on a tax-free basis, subject to the FHSA annual and lifetime contribution limits. Although such transfers would be subject to FHSA contribution limits, they would not be deductible and would also not reinstate an individual's RRSP contribution room. Such a transfer could be helpful if an individual plans to purchase a first home and has available FHSA contribution room (but no non-registered funds available to contribute to their FHSA, as the RRSP transfer will not be taxable if used to fund a qualifying home purchase. Alternatively, the individual could consider borrowing to top-up the FHSA in advance of purchasing the home.

Treatment of FHSA income for tax and income-tested benefit purposes

Income, losses and gains on investments held within an FHSA, as well as qualifying withdrawals, are not included (or deducted) in computing the plan holder's income for tax purposes. In addition, such amounts will not be considered in determining eligibility for income-tested benefits or credits delivered through the income tax system (for example, the Canada Child Benefit and the Goods and Services Tax Credit).

Eligible issuers

Any financial institution that is able to issue RRSPs and TFSAs would be able to issue FHSAs. This includes Canadian trust companies, life insurance companies, banks and credit unions.

Interaction with the Home Buyers' Plan (HBP)

The HBP would continue to be available as under existing rules. However, an individual would not be permitted to make both an FHSA withdrawal and an HBP withdrawal in respect of the same qualifying home purchase.

Spousal contributions and attribution rules

The FHSA holder will be the only taxpayer permitted to claim deductions for contributions made to their FHSA. In other words, individuals will not be able to contribute to their spouse or common-law partner's FHSA and claim a deduction.

However, an individual will be able to contribute to their FHSA from funds provided to them by their spouse. There is an exception to the "attribution rules" that will allow individuals to take advantage of the FHSA contribution room available to them using funds provided by their spouse. As a result, the income attribution rules will not apply to income earned in an FHSA that is earned on such contributions.

Marital breakdown

On the breakdown of a marriage or a common-law partnership, amounts may be transferred directly from the FHSA of one partner to an FHSA, RRSP, or RRIF of the other partner. Such transfers would not re-instate any contribution room of the transferor and would not be counted against any contribution room of the transferee.

Over-contribution, non-qualified investment, prohibited investment, and advantage taxes

Like TFSAs, a 1% tax on over-contributions to an FHSA would apply for each month (or a part of a month) to the highest amount of such excess that exists in that month.

When a taxpayer's annual contribution limit is reset at the beginning of each calendar year, over-contributions from a previous year may cease to be an over-contribution. A taxpayer will be allowed to deduct an over-contributed amount for a given year in the tax year in which it ceases to be an over-contribution. However, if a qualifying withdrawal is made before an over-contribution ceases to be an over-contribution, no deduction would be provided for the over-contributed amount.

The *Income Tax Act* imposes other taxes in certain circumstances involving non-qualified investments, prohibited investments, and unintended advantages in respect of other registered plans. These rules would also apply to the FHSA.

Treatment upon death

Like TFSAs, individuals can designate their spouse or common-law partner as the successor account holder, in which case the account might maintain its tax-exempt status. If named as the successor holder, the surviving spouse would become the new holder of the FHSA immediately upon the death of the original holder **provided the surviving spouse meets the eligibility criteria to open an FHSA**. Inheriting an FHSA in this way would not impact the surviving spouse's contribution limits. Inherited FHSAs would assume the surviving spouse's closure deadlines. **If the surviving spouse is not eligible to open an FHSA, amounts in the FHSA funds could instead be transferred to an RRSP or RRIF of the surviving spouse, or withdrawn on a taxable basis.**

If the beneficiary of an FHSA is not the deceased account holder's spouse or common-law partner, the funds would need to be withdrawn and paid to the beneficiary. Amounts paid to the beneficiary **would be included in**

the income of the beneficiary for tax purposes. When such payments are made, the payment to the beneficiary would be subject to withholding tax.

Non-residents

Taxpayers will be allowed to contribute to their existing FHSAs after emigrating from Canada, but they will not be able to make a qualifying withdrawal as a non-resident. In other words, a taxpayer must be a resident of Canada at the time of the FHSA withdrawal and up to the time a qualifying home is bought or built.

Deposit insurance framework

The *Canada Deposit Insurance Corporation Act* will be amended to create a new category of insured deposits for FHSAs, as is the case for RRSPs and TFSAs.

Interest deductibility/collateralization

Like RRSPs and TFSAs, interest on money borrowed to invest in an FHSA will not be deductible in computing income for tax purposes. In additional plan holders must include in income the full value of any assets held within an FHSA that are pledged as collateral for a loan.

Bankruptcy

FHSAs will not be afforded creditor protection under the *Bankruptcy and Insolvency Act*.