Tax-Free First Home Savings Account: Estate Implications and Income Splitting Opportunities

On April 1, 2023, the Tax-Free First Home Savings Account ("**FHSA**") was introduced by the Federal Government as a supplementary method for Canadians to save for their first home. After an initial period of limited availability, FHSAs are now offered alongside RRSP's and TFSA's at most major financial institutions. Individuals seeking to maximize the impact of these accounts should bear in mind two considerations: the treatment of FHSAs on death, and the unique income splitting opportunity they offer.

Overview of FHSA's

FHSAs are designed as a "best of both worlds" model. They combine the tax-deductible contributions central to RRSPs with the tax-free withdrawal of contributions, income, and growth features of a TFSA.

To be eligible to open a FHSA, an individual must be a resident of Canada, at least 18 years old, and a first-time homebuyer.

An eligible individual can contribute a lifetime maximum of $40,000 on a tax-deductible basis to an FHSA, with an annual contribution limit of $8,000. If an annual contribution is less than $8,000, the account holder can carry forward the unused amount from the previous year. Accordingly, an individual who opens an FHSA in 2023, and makes no contributions prior to year end will be eligible to contribute up to $16,000 in 2024.

Transfers from an FHSA

An FHSA can remain open for the Maximum Participation Period ("MPP"), defined as the earlier of: the 15th anniversary of account opening; the year the account holder turns 71; and the year the account holder makes his or her first qualifying withdrawal.[1] At the end of the MPP, any amounts remaining in the FHSA will be included in that year's income.

Fortunately, this income inclusion can be avoided. The holder of an FHSA is permitted to transfer the balance on a tax-free basis to an RRSP. Notably, such a transfer will not use any of the individuals RRSP contribution room.

The FHSA design therefore allows an individual who does not end up purchasing a home (or who has no intention of purchasing a home) to open a FHSA, contribute the maximum $40,000 over 5 years, and subsequently transfer $40,000, plus income and growth, to an RRSP on a tax-free basis, without a corresponding reduction to their RRSP contribution limit. In effect, the strategy permits the individual to create additional RRSP room of $40,000 + up to 15 years of tax-free income and growth.

Income Splitting

Unlike an RRSP, only the account holder, and not his or her spouse, may contribute to a FHSA. However, a high-income spouse is free to make annual gifts of $8,000 to his or her lower income spouse. Those gifted funds can then be contributed by the lower income spouse to their FHSA. Pursuant to s. 74.5(12)(d) of the *Income Tax Act*, inter-spousal gifts or loans that are contributed to an FHSA will not trigger the income attribution rules that would otherwise cause the income generated by the gifted funds within the FHSA to be taxed at the marginal rate of the higher-income spouse. This is true even when the funds are withdrawn. Any income and growth from the gifted funds will instead be tax-free within the FHSA.

The lower income spouse's contributions of the gifted funds to the FHSA will also be tax deductible in the same manner as an RRSP.[2] The deductions may be retained by the spouse for use in a later year if their income is expected to increase.

Parents with children who are 18+ can employ a similar strategy. The child or children can open an FHSA, and the parent can make annual gifts of $8,000 to the child for 5 years. The growth and income of the $40,000 contributed by the child to his or her FHSA will be tax-free, without income attribution to the parent. The child will likewise benefit from the tax-deductible contributions to the FHSA, which they can retain for use in a later year if they have a low income which is expected to grow. This strategy may be particularly well-suited for parents with children in College or University, as such children can apply the deductions after graduating when their income is expected to increase.

Example: At age 18 a child begins making contributions of $8,000/year for 5 years to his or her FHSA from funds gifted by a parent. Assuming a 6% annual rate of return, the funds will grow on a tax-free basis to approximately $64,000 when the child turns 28, and approximately $86,000 at the end of the MPP when the child turns 33. If the child applies the funds towards the purchase of a first home, the full amount can be withdrawn and applied tax-free. Assuming the child's marginal tax rate is 25%, they will also have $10,000 of tax deductions originating from the $40,000 in FHSA contributions.

On Death: Avoiding Estate Administration Tax

There are several estate planning options where an individual dies while holding an FHSA:

1. The account holder can designate a spouse who is a qualifying individual[3] as successor holder. If the spouse does not own an FHSA, they will become the new account holder without any taxes payable. If the surviving spouse has a pre-existing FHSA, they will become the new holder of the deceased's FHSA, without affecting the annual or lifetime contribution room in their own FHSA.
2. The account holder can designate a spouse who is not a qualifying individual as successor holder, and the FHSA can be transferred directly to the non-qualifying spouse's RRSP or RRIF on a tax deferred basis.
3. The account holder can designate a spouse or other individual as a beneficiary of the FHSA. That individual must include the fair market value of the FHSA in their income in the year it is received.

In each case, the FHSA will not form part of the deceased's estate, avoiding Ontario's Estate Administration Tax. If the account holder does not name a successor holder or beneficiary, or names their estate as the beneficiary, Estate Administration Tax will be charged on the fair market value of the FHSA.

Like a TFSA, the account holder may appoint a successor holder directly in their Will or through the form used by the financial institution. If permitted by Provincial law, a beneficiary may be appointed in the FHSA forms used by the relevant financial institution. Although Ontario's *Succession Law Reform Act*[4] has not been amended to permit the appointment of beneficiaries in an FHSA form, a review of the FHSA forms used by most major financial institutions suggest that such institutions will honor the beneficiary designation in their forms if an indemnity is provided.

Conclusion

FHSAs offer a rare income splitting opportunity between spouses. The ability to carry forward unused contributions from the previous year and transfer FHSA funds to an RRSP or RRIF without using contribution room suggests these accounts are most effective when opened early. For individuals who own FHSAs, it is important to understand the effect of different appointment options on death, and how such appointments can avoid the FHSA being subject to Estate Administration Tax within an estate.

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[1] A withdrawal used towards the purchase or construction of a qualifying home. See https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/first-home-savings-account/definitions.html

[2] Unless such funds are transferred from the higher-income spouse's RRSP

[3] See https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/first-home-savings-account/definitions.html

[4] *Succession Law Reform Act*, R.S.O 1990, c. S.26

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