



Proposed Changes to TFSA Rules to Target Tax Planning Schemes

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On Friday, October 16, 2009, the Minister of Finance announced certain anti-abuse amendments to the tax-free savings account (“TFSA”) rules in the *Income Tax Act* (Canada) (the “Tax Act”). The proposed amendments are intended to prevent the “...use of inappropriate transactions to draw excessive benefits...”. Generally, these amendments will not affect most investors. Rather, these new rules are directed at sophisticated investors and traders who exploit the TFSA framework to convert otherwise taxable gains into tax-free gains and inappropriately increase the contribution rooms for their TFSAs.

General Description of TFSAs

TFSAs were introduced in the 2008 Federal Budget as another type of tax-advantaged registered account, like Registered Retirement Savings Plans (“RRSPs”), to encourage Canadians to save. Canadian residents who are 18 years of age or older are eligible to contribute no more than \$5000 each year to a TFSA. Contributions to TFSAs are made out of after-tax dollars as such contributions are not deductible for tax purposes. However, investment income, including capital gains, are earned tax-free in a TFSA. TFSA withdrawals are not subject to tax and are added to the contribution room of the individual for the following year.

Summary of Proposed New Rules Affecting TFSAs

The new TFSA rules will address 3 types of abuses identified by the Department of Finance: asset transfer transactions, deliberate over-contributions, and investments of prohibited investments and non-qualified investments in TFSAs.

i. Asset Transfer Transactions. Asset transfer transactions refer to transfers of property for cash or other property between registered accounts, e.g., transfers from a RRSP to a TFSA. Since such transfers are not treated as withdrawals and recontributions, the transfer from the RRSP is not subject to tax. The new rules are directed at taxpayers who engage in frequent transfers of this type to effectively shift increased asset values from RRSPs to TFSAs on a tax-free basis but without a genuine intention to dispose of the assets.

To prevent these types of transfers, the new rules will effectively prohibit asset transfer transactions between registered and non-registered accounts and TFSAs that are owned by (i) the same individual or (ii) an individual and another person with whom the individual does not deal at

arm’s length for the purposes of the Tax Act. Furthermore, where a TFSA amount may reasonably be attributed to an asset transfer transaction, a 100% tax on the TFSA amount will be triggered if new anti-avoidance “advantage rules” apply to the transaction. Generally, where the transaction or event would not have occurred in an open market in which parties deal with each other at arm’s length and act prudently, knowledgeably and willingly, the advantage rules will apply to such transfers or events and trigger the 100% tax. However, where such transfers are made inadvertently and the taxpayer promptly restores each account to its original position prior to the transfer, the Minister of National Revenue will have discretion to waive or cancel all or part of the tax payable. Moreover, the Minister of National Revenue will have the authority to adjust the contribution room of the TFSA for the taxpayer accordingly.

ii. Deliberate Over-contributions. Tax planning schemes have evolved to take advantage of the following structural aspects of TFSAs: (i) contributions and income earned on such contributions accrue tax-free in a TFSA, (ii) withdrawals from TFSAs are not subject to tax, and (iii) over-contributions to TFSAs are subject to a tax of 1% per month on the highest amount of the excess contributions for the month. As part of a tax planning scheme, a taxpayer would over-contribute to his or her TFSA for a short period of time where the rate of return on such over-contribution exceeded the 1% penalty for the over-contribution. In order to address this unexpected abuse, the proposed advantage rules described above will apply a 100% tax on the income that is reasonably attributable to such deliberate over-contributions. However, the Minister of National Revenue will maintain discretion and authority in these circumstances as well to waive or cancel all or part of the tax payable and to adjust the taxpayer’s TFSA contribution room as appropriate in the particular circumstances.

iii. Prohibited Investments and Non-Qualified Investments. Similar tax planning schemes have also developed in respect of prohibited investments and non-qualified investments being held in TFSAs. Qualified investments generally include shares or debt of public corporations or publicly listed corporations. Non-qualified investments generally include land or general partnership interests. The prohibited investment rules were developed to prevent the creation of self-dealing advantages for the holders of TFSAs. Thus, prohibited investments include shares of the capital stock of a corporation in which the holder holds a 10% or greater interest.

Under the existing rules, the negative tax consequences of holding prohibited and non-qualified investments in a TFSA are significant. However, the investment income earned on such investments in a TFSA is not taxed. This gives rise to a permanent increase in both the savings in the TFSA and the contribution room of the TFSA. As a result, in respect of prohibited investments, the new rules will tax such income at 100% to the extent that the advantage rules

apply to the prohibited investment which gave rise to such income. The taxes that are triggered as a result of a prohibited investment being held in a TFSA will no longer apply once the new rules are enacted into law. Correspondingly, in respect of non-qualified investments, the new rules will tax at regular combined federal and provincial income tax rates any income that is reasonably attributable to a non-qualified investment held in a TFSA. Thus, income earned on income earned on a non-qualified investment held in a TFSA will be subject to the federal/provincial regular income tax rate. Under the existing rules, only the investment income of such a non-qualified investment is taxed as regular income and these income amounts are not required to be removed from the TFSA.

Withdrawal Changes

As noted above, amounts withdrawn from a TFSA in one year will increase a taxpayer's contribution room by the amount that is withdrawn in the next year. In order to prevent the creation of additional TFSA contribution room from amounts in respect of the three types of abusive transactions described above, the proposed amendments will include rules to ensure that the withdrawal of amounts in respect of these types of transactions and income related to those amounts do not qualify as distributions for TFSA purposes.

Effective Application Date of the New Rules

These new changes to the TFSA rules will not apply to transactions that occurred on or before October 16, 2009. Thus, withdrawal of amounts related to such transactions prior to October 16, 2009 will not be subject to these proposed rules. Any transactions entered into after October 16, 2009 will be subject to the new rules, provided that they are enacted into law.

This update is intended as a summary only and should not be regarded or relied upon as advice to any specific client or regarding any specific situation.

If you would like further information regarding the issues discussed in this update or if you wish to discuss any aspect of this commentary, please feel free to contact us.

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