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TFSA advantage can lead to a tax of 100%

Next time a client has a desire to play games with his TFSA, point out this harsh — but legally valid — punitive tax

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Clients sure do love their TFSAs. The ability to earn tax-free investment income and gains for life, coupled with the flexibility to withdraw funds, tax-free, at any time and for any purpose — then recontribute the amounts

withdrawn in a subsequent year — make these savings vehicles a favourite among millions of Canadians.

For some, the temptation to manipulate the completely tax-free nature of TFSAs is too great to resist, which is why there are several anti-avoidance rules in the Income Tax Act to prevent abuse and manipulation of all registered plans, including not only TFSAs, but RRSPs, RRIFs, RESPs and RDSPs.

Earlier this month, the Canada Revenue Agency (CRA) published an extensive Income Tax Folio going through what's known as the "advantage rules" for registered plans and providing numerous examples of how the anti-avoidance rules work and when they might apply. That's because if they do apply, the result is extremely harsh.

How harsh? Well, if clients find themselves offside, they could face a 100% penalty tax on the fair market value of any "advantage" they receive that's related to a registered plan. The CRA does have the ability to waive all or part of the tax "in appropriate circumstances." Although the advantage rules applied only to TFSAs originally, they were extended to RRSPs and RRIFs in early 2011 and to RESPs and RDSPs in early 2017.

The advantage rules are part of a broader set of rules in the Income Tax Act that govern registered plans. For example, as most advisors will know, these plans can invest only in "qualified investments" (such as publicly traded stocks and bonds, mutual funds and guaranteed investment certificates) and must not invest in property that is a "prohibited investment" (generally, private company shares or debt in which the planholder has a significant interest).

In addition, registered plans must avoid investments or transactions that are structured to "artificially shift value into or out of the plan or result in certain other supplementary advantages." According to the CRA, "These rules … represent overriding investment restrictions for registered plans intended to guard against abusive tax planning."

The CRA further states that the rules are intended mainly to target abusive tax-planning arrangements "that seek to artificially shift value into or out of a registered plan while avoiding" the typical contribution limits for registered plans, such as the current $5,500 TFSA annual dollar limit or the 2018 maximum RRSP deduction limit of $26,230 — or 18% of the prior year's earned income, if lower.

One example of an advantage is a deliberate overcontribution to a TFSA in which an individual intentionally contributes more to her TFSA than her TFSA contribution limit allows with a view to generating a rate of return sufficient to outweigh the cost of the regular TFSA overcontribution tax of 1% a month.

A recent decision of the Tax Court of Canada, also out this month, revealed that the government can assess a 100% tax applicable to the advantage — essentially amounting to a potential confiscation of a client's entire TFSA. The case involved a taxpayer who was reassessed almost $125,000 in penalty taxes applicable to the advantage the CRA says he received in connection with the transfer of private company shares to his TFSA.

The taxpayer went to court to challenge the constitutionality of the 100% advantage tax on two grounds. The first was that a 100% tax "fell within the provincial jurisdiction of property and civil rights … since the 100% tax rate was a confiscation of property and was not necessary to the effective exercise of the federal taxation power as it overreached what was necessary to meet the aims of the section."

The taxpayer's second argument was that because the CRA has the discretion to reduce the 100% advantage tax to zero, "Parliament … improperly delegated the rate-setting element of (tax) … to the (CRA) … in contravention of … the Constitution Act."

Not surprising, the court disagreed with the taxpayer, concluding that the rule taxing the advantage at 100% did not infringe on the right to make laws respecting property and civil rights on the basis that the section was "in pith

and substance” taxation and “fell within a valid TFSA scheme of taxation within a valid (Tax Act).”

The judge, upholding the 100% advantage tax, concluded, “The provisions are clear, were properly passed by Parliament into law … and are constitutionally valid.”

So, next time a client has a desire to play games with his TFSA, point out this harsh — but legally valid — 100% tax.