Active investors targeted as CRA demands $75-million be returned after TFSA audits

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The Canada Revenue Agency has demanded the return of more than $75-million as a result of audits it has conducted over the past five years of tax-free savings accounts, including some TFSAs that swelled to more than a million dollars through aggressive securities trading.

The audits are prompting calls – especially from those in the financial advisory community – for better clarity on tax rules surrounding the popular investment vehicle.

TFSAs were first introduced in 2009 and now allow anyone over the age of 18 to contribute $5,500 annually into an account that grows tax-free. The TFSA currently provides up to $52,000 of cumulative contribution room to allow investment income to grow tax-free.

Of the $75-million, approximately 20 per cent of the funds resulted from audits which looked at TFSA accounts that were seen as carrying on a business, such as day-trading. (While the CRA allows trading it deems to be passive, carrying on a business within an account may preclude returns from qualifying as tax-free.)

The CRA says the remaining assessments, which make up majority of the $75-million, have been from other non-compliant actions – such as over-contributing to accounts. If, at any time, deposits exceed TFSA contribution room for the year, the taxpayer may be subject to the TFSA tax on excess contributions. TFSA holders are liable for a 1-per-cent tax every month on their highest excess TFSA amount in each month. This tax will accumulate until the excess amount is withdrawn. If an account holder has excess contributions, they should withdraw the funds immediately to avoid any additional tax. (The CRA makes exceptions to waive the 1-per-cent tax in certain cases.)

While the vast majority of TFSA holders are using the accounts as intended, there are a small number using these accounts in aggressive tax planning, the Canada Revenue Agency says.

"Taxpayers have built multimillion-dollar TFSA balances by manipulating the prices in non-arm's length transactions; for example, buying and selling shares in a privately held corporation that they fully control so that the value comes to reside within the TFSA, where it can grow tax-free," a CRA spokesperson said.

"Initially, I don't think the issue of actively trading in a TFSA or 'carrying on a business' was given a lot of thought when the initial contribution limit was a mere $5,000 – that really limits the amount of trading you can do," says Jamie Golombek, managing director of tax and estate planning at CIBC Wealth Strategies Group.

"The TFSA really started out as a savings account – which of course is a bit of a misnomer because we also promote them as tax-free investment accounts. But as the contributions limits got bigger, and the markets got better, people realized they could do more than just open up a savings account with a TFSA."

The CRA began auditing TFSAs in 2011, following the 2009 legislative amendments proposed by the Minister of Finance to address concerns that arose at the time regarding the use of TFSAs in tax-planning schemes. Now with the CRA reviewing these accounts, a TFSA that is seen as "carrying on a business" may see its income and gains subject to income tax, potential penalties and daily compound interest.

While buying and selling of shares is a common activity within many TFSAs, there are certain situations where an account can be found to be carrying on a business, and therefore profit could be taxed as business income.

The CRA could not identify direct examples of concern, but did say CRA reviews TFSA accounts with holdings several times greater than the contribution limit, and from those reviews it has selected fewer than 1 per cent for audit because the activity indicated use beyond the legislative intent.

Large increases in an account could relate to non-publicly traded shares or assets that are sold through an independent provider, such as a bank or investment firm.

"I think this issue of active trading inside a TFSA such that CRA considers it running a business has come down to a few experts and professionals that have done very well by doing multiple trades in TFSAs over the past number of years," Mr. Golombek said.

This could be concerning for many in the investment community who are using a TFSA for their own personal investments.

"Financial advisers, who are actively trading in their TFSA, would certainly be at a higher risk than the average person." Mr. Golombek added.

"It would depend on several things – the CRA would look at the volume of trades and the length of ownership of the securities. In addition, presumably advisers have extensive knowledge of the market, their profession is directly related to it, and they spend a lot of time researching securities. In addition, they often market themselves as someone who does that."

One of the issues that remains for all TFSA holders is a lack of guidance for investors on what can and cannot be done within an account, leaving investors in the dark about whether or not they are breaking tax rules. The Investment Industry Association of Canada (IIAC) has been vocal in the community about the need for greater clarity for both individual investors and investment dealers.

In 2016, the CRA released a tax guide that included a section on the tax consequences of carrying on a business in a registered plan, but the IIAC does not believe the guide provides sufficient clarity to taxpayers on what constitutes carrying on a business inside a TFSA.

"[We] continue to believe that TFSA investors could benefit from a clearer understanding of what trading activities could put them at risk of a CRA audit," Jack Rando, managing director at the IIAC, said in an e-mail to The Globe and Mail.

During a CRA roundtable discussion in early June that was hosted by the Society of Trust and Estate Practitioners, the CRA was asked whether it had any plans to educate the public on what the acceptable limits are on securities trading to prevent a TFSA account from being considered to be carrying on a business.

"As there is nothing unique about TFSAs in the context of securities trading, there is no plan to provide any additional guidance specific to TFSAs," said Steve Fron, manager of the trusts section of the income-tax rulings directorate of the CRA, in response to the roundtable question.

To establish whether trading activities constitute the carrying on of a business, the CRA reviews accounts on a case-by-case basis and considers a number of factors to determine whether an account is offside, including the frequency of transactions, the account holder's knowledge of the stock market, how long the security has been held for, the account holder's profession and the type of the shares held.

Kim Moody, a Calgary-based lawyer with Moody's Gartner Tax Law firm, says the CRA's analysis is short shrifted and the assessment doesn't go deep enough for many of the taxpayers he has been disputing reassessments for.

"We have a number of files where they are under audit and the trigger for the audit appears to that the TFSA has big wins and that seems to be it," Mr. Moody says. "It appears to be almost automatic that the CRA will take the position that they are trading their securities on account of business income and therefore taxable. The assertion of whether securities trading is on account of business is not a black-and-white issue. It's actually quite a tough issue and unfortunately we are seeing a fairly black-and-white assessment by the CRA in some cases."

"As for the general population, investors continue to be confused with the rules in TFSAs, particularly on transfers," Mr. Golombek said.

"If you want to move from TFSA at institution A to a TFSA at institution B – many people simply withdraw the funds out of one institution and walk across the street and deposit it into the other. That often leads to an inadvertent over-contribution since it wasn't done as a direct transfer."

Eight factors the CRA takes into consideration when determining if a TFSA is carrying on as a business:

- Frequency of transactions: A history of extensive buying and selling of securities or of a quick turnover of properties.
- Period of ownership: Securities are usually owned only for a short period of time.
- Knowledge of securities markets: The taxpayer has some knowledge of or experience in the securities markets.
- Security transactions form a part of a taxpayer’s ordinary business.
- Time spent: A substantial part of the taxpayer’s time is spent studying the securities markets and investigating potential purchases.
- Financing: Security purchases are financed primarily on margin or by some other form of debt.
- Advertising: The taxpayer has advertised or otherwise made it known that he is willing to purchase securities.
- In the case of shares, their nature – normally speculative in nature or of a non-dividend type.