

## The Tax-Free Savings Account – An Analysis of the Legislation

The Department of Finance predicts that Tax Free Savings Accounts (TFSA) are set to become a *major* component of Canadians' financial plans – so much so that 90% of Canadians will eventually keep all of their financial assets in tax-efficient vehicles such as TFSA and Registered Retirement Savings Plans (RRSPs). If you don't have a thorough understanding of how these accounts work and what they offer, now is the time to brush up. To help you, this edition of *Taxing Issues* reviews the current legislation, and also identifies areas that will be modified by proposals contained in draft legislation released July 14, 2008.

### I. Basics

Canadian taxpayers 18 and over will be able to open TFSA starting with the 2009 taxation year. Contributions to TFSA in 2009 will be limited to a modest (but indexed) \$5,000 per taxpayer, but do not underestimate their potential. Remember that RRSPs also had a modest start in 1957, with annual contributions being limited to a maximum of \$2,500 (\$1,500 for participants in an employer-sponsored pension plan). In 2005 Statistics Canada estimated that holdings in RRSPs and Registered Retirement Income Funds (RRIFs) (including locked-in accounts) amounted to \$593 billion.<sup>1</sup> There is no doubt that with the passage of time there will be significant accumulations in TFSA. It is anticipated that in a five-year span, the TFSA market will be \$115 billion.<sup>2</sup>

### II. Primary Features

TFSA are flexible, general-purpose savings vehicles that will allow Canadian taxpayers 18 and over to make annual contributions. Withdrawals are permitted at any time, and there are no time limits as to when withdrawals must commence.

While contributions to TFSA are not deductible for tax purposes, TFSA income (including capital gains) is not taxable. Furthermore, distributions from the TFSA are not subject to tax.

Contributions are limited to (an indexed) \$5,000 per annum. Unmade contributions will be added to contribution room. Distributions from the TFSA will replenish the contribution room (i.e., will be added to the contribution room in the following year). Thus, where amounts are withdrawn from a TFSA, these amounts may be recontributed, with this being allowed in addition to regular contributions. TFSA holders should carefully monitor contribution amounts because a 1% per month penalty applies to excess contributions. They must also strive to hold only permitted investments, as penalties and other taxes will apply where this is not the case.

#### (a) Holders

The "holder" will be the person who enters into the contract with the issuer of the TFSA. A spouse (or common-law partner, including a same-sex partner) can be designated as a "successor holder" (our term) of the TFSA, providing that when this person becomes the holder, he or she has the unconditional right to revoke any beneficiary designations (or similar directions) made by the original "holder". Finance

<sup>1</sup> See *The Wealth of Canadians: An Overview of the Results of the Survey of Financial Security*, as published by Statistics Canada in 2005

<sup>2</sup> See *The New Tax-Free Savings Account: How Popular Will It Be*, by Benjamin Tal, in *Consumer Watch Canada (CIBC World Markets)*, September 11, 2008.

introduced these rules as it intended that the survivor, on becoming the holder, have control over the arrangement.<sup>3</sup>

Couples setting up TFSAs will have to decide whether to designate the other partner as a “successor holder”, designate a beneficiary under the contract (or will), or simply have the TFSA assets paid to the estate. Where the partner is a “successor holder”, the partner will essentially step into the shoes of the deceased holder upon the death of the original holder. This allows for a smooth transition.

A holder may open any number of TFSAs, subject to his or her contribution limit.

(b) Issuers

Trust companies, licensed annuities providers, credit unions and members of the Canadian Payments Association can all issue TFSAs<sup>4</sup>.

**Section III** reviews qualified investments of the TFSA. Note that the attributes of a specific investment (e.g., annuity) may vary depending upon who the issuer is.

(c) Qualifying Arrangements

A number of conditions must be met for an arrangement to qualify as a TFSA.

- ✓ The individual (other than a trust) entering into the arrangement with the issuer must have attained age 18
- ✓ The issuer must be a party described in (b) above
- ✓ Contributions to the arrangement must be used, invested or otherwise applied by the issuer to make distributions under the arrangement to the holder
- ✓ The individual and the issuer must agree that the issuer will register the arrangement with the Minister of the Canada Revenue Agency (CRA) as a TFSA
- ✓ Throughout the period that the arrangement is a TFSA it must meet the conditions required of TFSAs.<sup>5</sup>

In terms of age requirements, the holder must actually have reached his or her 18th birthday. It is not a question of simply opening a TFSA in the calendar year in which the person attains age 18.

(d) Conditions that a “qualifying arrangement” must meet

The “qualifying conditions” that must be met for an arrangement to be a TFSA are:

- ✓ The arrangement must be maintained for the exclusive benefit of the holder (except for any rights arising as a consequence of the death of the holder)
- ✓ A party other than the holder or issuer of the TFSA can have no rights as to the amount or timing of distributions from the TFSA, nor with respect to the investing of the funds
- ✓ Only the “holder” may make contributions
- ✓ Distributions may be made to reduce taxes otherwise payable with respect to excess contributions or contributions made while the holder was non-resident
- ✓ The holder may direct the issuer to transfer property (or an amount equal to its value) to another TFSA of the holder
- ✓ A TFSA trust may not borrow funds or other property
- ✓ Certain prescribed conditions are met.<sup>6</sup>

<sup>3</sup> See definition of “holder” in subsection 146.2(1) of the ITA.

<sup>4</sup> See definition of “issuer” in subsection 146.2(1) of the ITA.

<sup>5</sup> See definition of “qualifying arrangement” in subsection 146.2(1) of the ITA.

<sup>6</sup> See subsection 146.2(2) of the ITA.

There are no “prescribed conditions” at this time, but the legislation allows regulations to be released at a later time.

An arrangement will be a TFSA at the time it is entered into if it is a “qualifying arrangement” at that time and provided the issuer files an election with CRA to register the arrangement within 60 days after the year in which the arrangement was entered into. (The July 14, 2008 draft legislation proposes changing the filing deadline to the last day of February.<sup>7</sup> It is anticipated that the timely filing of the information return for the TFSA will constitute a valid election.<sup>8</sup>)

While an arrangement qualifies as a TFSA, it cannot qualify as another type of registered plan (i.e., as a RRSP, Registered Retirement Income Fund (RRIF), Registered Educational Savings Plan (RESP) or Registered Disability Savings Plan (RDSP).)<sup>9</sup>

(e) TFSA Dollar Limit

As stated above, at the inception of the TFSA regime, the “TFSA dollar limit” is \$5,000. This amount is indexed to inflation, with the \$5,000 that is available in 2009 being indexed and rounded to the nearest \$500 in subsequent years.<sup>10</sup>

If we assume 2% indexation, the result is \$5,100 in 2010 and \$5,202 in 2011. There is no actual increase to the “TFSA dollar limit” until 2012, when the result reaches \$5,306. It would then jump to \$5,500, which is the nearest \$500. (In fact, as soon as it hit \$5,250, the TFSA limit would be bumped to \$5,500.) Subsequent indexation would proceed from the new \$5,500 base.

(f) Unused Contribution Room

As with the RRSP regime, contribution room will be calculated for TFSAs. CRA will report the amount on annual Notices of Assessment. This would suggest that filing of a tax return is required even where there is no taxable income, although we understand that CRA intends to accommodate cases where this has not been done. We assume more clarity will emerge on this in due course.

This contribution room may be positive or negative. It is calculated as follows:

Unused contribution room at the end of the preceding year  
Plus: Distributions made in the preceding year other than qualifying transfers or prescribed distributions  
Plus: TFSA dollar limit for the year if the person is age 18 or older and resident in Canada  
Less: Contribution made by the individual in the year, except for qualifying transfers and exempt contributions

Let’s assume Sam could contribute \$5,000 to his TFSA in 2009 but does not. This “contribution room” will be carried forward to 2010. Here we ignore indexation and assume the 2010 limit is again \$5,000. Sam could thus contribute \$10,000 in 2010. If he in fact contributed just \$8,000, he would carry \$2,000 forward to 2011.

The contribution room will be calculated starting with the taxation year in which an individual attains age 18 (excluding years during which the individual is not resident in Canada). Unused room is carried forward indefinitely – it does not expire!

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<sup>7</sup> See proposed subsection of the *Legislative Proposals and Explanatory Notes relating to the Income Tax Act, the Excise Act, 2001 and Excise Tax Act*, as introduced on July 14, 2008 (July 14, 2008 Draft Legislation).

<sup>8</sup> See also proposed subsection 146.2(13), which allows the Governor in Council to make regulations with respect of the filing of information returns for the TFSA.

<sup>9</sup> See subsection 146.2(9) of the ITA. See proposed subsection 146.2(12) the July 14, 2008 Draft Legislation.

<sup>10</sup> See definition of “TFSA dollar limit” in subsection 207.01(1) of the ITA.

“Qualifying transfers” are certain plan-to-plan transfers (e.g., upon marriage breakdown), and are discussed in **Section IV part (a)**. “Prescribed distributions” are discussed in **Section IV part (d)**.

We anticipate that TFSAs will play a large part in allowing for essentially tax-free intergenerational wealth transfers. Imagine that Sam dies with a large balance in his TFSA. His beneficiaries may be at a stage in life where they do not have the funds to contribute to a TFSA and thus have built up significant “room”. The bequest will represent a source of funds that can be used to make contributions to their TFSAs. Hence, they will now be able to tax-shelter investment earnings on these assets.

Note that contributions are determined on a calendar year basis. People who want to maximize their tax-free savings should contribute at the start of the year.

(g) Tax-Exempt Status of Trust (including Loss of this Status)

TFSA status is lost: (1) upon the death of the last holder, (2) when the arrangement ceased to qualify, or (3) when the arrangement is not administered in accordance with the conditions outlined in (d) immediately above.<sup>11</sup> The legislation is being clarified to specify that the loss of the TFSA status occur at the earliest of these times.<sup>12</sup>

Generally, no taxes are payable by the TFSA trust.<sup>13</sup> However, taxes will arise where:

- a. The trust carries on a business or if it holds “non-qualified investments” or “prohibited investments”<sup>14</sup>
- b. Excess contributions are made to the TFSA<sup>15</sup>
- c. Non-residents contribute to the TFSA<sup>16</sup>
- d. Supplementary advantages are extended<sup>17</sup>

An issuer of a TFSA that governs a trust must exercise care, diligence and skill of a reasonably prudent person with respect to ensuring that only qualified investments are held.<sup>18</sup>

Where a tax liability does arise, the appropriate trust return must be prepared on a calendar-year basis (as is the case with any inter vivos trust), with the return (and taxes owing) being due 90 days after year-end.<sup>19</sup>

A trust ceasing to be a TFSA loses its tax-exempt status at that time.<sup>20</sup> Where this happens, a new taxation year will begin for the trust. The trust is also deemed to acquire assets owned by it at Fair Market Value (FMV).<sup>21</sup>

Likewise, where a deposit ceases to be a TFSA, a deemed disposition arises, with the asset being deemed to be reacquired at FMV.<sup>22</sup>

With the deemed disposition rules outlined above, the TFSA will essentially accrue (non-taxable) income to the date that the exempt status is lost.

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<sup>11</sup> See subsection 146.2(3) of the ITA.

<sup>12</sup> See proposed subsection 146.2(5) of the July 14, 2008 Draft Legislation.

<sup>13</sup> See paragraph 149(1)(u.2) of the ITA.

<sup>14</sup> See subsection 207.04 of the ITA.

<sup>15</sup> See subsection 207.02 of the ITA.

<sup>16</sup> See subsection 207.03 of the ITA.

<sup>17</sup> See subsection 207.01(1) for the definition of “advantage”. See also subsection 207.05 of the ITA for additional taxes that are payable certain “advantages” are extended to persons who do not deal at arm’s length with the holder of the TFSA. The proposed revision to the definition of “advantage” per the July 14, 2008 Draft Legislation.

<sup>18</sup> See subsection 207.01(5) of the ITA.

<sup>19</sup> See subsection 207.07 of the ITA.

<sup>20</sup> See subsection 146.2(4) of the ITA. Renumbered as subsection 146.2(6) per the July 14, 2008 Draft Legislation.

<sup>21</sup> See subsection 146.2(6) of the ITA. Renumbered as subsection 146.2(8) per the July 14, 2008 Draft Legislation.

<sup>22</sup> See subsection 146.2(8) of the ITA. Renumbered as subsection 146.2(11) per the July 14, 2008 Draft Legislation.

#### (h) Tax-Free Status of Products Issued by Licensed Annuities Providers

The ITA has also been amended to clarify that where a segregated fund policy is issued as a TFSA, there will be no income in the hands of the holder.<sup>23</sup> Also, a non-prescribed annuity will be exempted from the accrual rules. Similar rules will apply to prescribed annuities.<sup>24</sup>

Furthermore, specific tax rules provide that where interest (or other income) is credited to a deposit, this income is not considered to be income to the TFSA holder.<sup>25</sup>

If an annuity contract ceases to be a TFSA, a deemed disposition of this contract arises. As with assets owned by a trust, there is a deemed disposition at FMV. A separate contract is then considered to have been issued.<sup>26</sup>

The penalties described in respect of non-resident contributions and advantages apply to annuity contracts as well.

#### (i) Distributions from TFSA are not Included in Net Income

Most distributions from TFSAs will not be included in net income. (Only upon the death of the holder of a trust may there be a taxable portion to the beneficiary (or estate) that relates to investment income accruing after the date of death.)

The ITA has rules that require that certain tax-free amounts be included in “net income” and then be deducted in calculating “taxable income”. These rules apply to certain social assistance payments and certain other sources of income. With the amounts being deducted in calculating taxable income, no income taxes arise with respect to these amounts. However, with the amounts being included in “net income”, they do affect many calculations (e.g., Old Age Security (OAS) clawbacks, claims by seniors for the Guaranteed Income Supplement (GIS), etc.).

Since TFSA payments generally do not form part of “net income”, TFSAs will be attractive for many taxpayers, especially seniors who are concerned about GIS entitlements, OAS clawbacks, etc.

### III. Qualified Investments

As stated above, there are variances in what investments various issuers may make available.

#### (a) Contracts issued by Licensed Annuities Providers

A licensed annuities provider can issue a stand-alone contract qualifying as a TFSA. Here, anything qualifying as an “annuity” within the meaning of the licensing legislation may be offered. The ITA, as originally enacted, contained a requirement that the contract not be adjoined to another contract or arrangement.<sup>27</sup> This condition was apparently originally included to preclude contracts commonly referred to as “split dollar arrangements”.<sup>28</sup> The draft legislation released by Finance on July 14, 2008 proposes eliminating the requirement that the contract not be adjoined to another contract.<sup>29</sup>

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<sup>23</sup> See subsection 138.1(7) of the IA.

<sup>24</sup> See proposed changes to subsection 304(1) of the Income Tax Act Regulation Regulations (Regulations).

<sup>25</sup> See subsection 146.2(5) of the ITA (renumbered as subsection 146.2(7) per the July 14, 2008 Draft Legislation), as well as subsection 7000(6) of the Regulations.

<sup>26</sup> See subsection 146.2(7) of the ITA. Renumbered as subsection 146.2(10) per the July 14, 2008 Draft Legislation.

<sup>27</sup> See part (b)(ii) of the definition of “qualifying arrangement” in subsection 146.2(1) of the ITA.

<sup>28</sup> See discussion of “qualifying arrangement”, as contained in Technical Notes accompanying July 14, 2008 Draft Legislation.

<sup>29</sup> See proposed part (b)(ii) of the definition of “qualifying arrangement” in the July 14, 2008 Draft Legislation.

Thus, licensed annuities providers may offer segregated fund contracts and other annuity contracts (including term fund contracts, as well as term certain and life annuity contracts on either a prescribed or non-prescribed basis). It is possible that not all insurers will offer all contracts. Certain product minimums, etc. may come into play.

A person contemplating contributing to a TFSA and acquiring an annuity should consider doing so on a direct basis, as opposed to doing so through a trust. This is beneficial, since many of the advantages that insurance contracts provide (ability to designate a beneficiary, creditor protection in some circumstances, etc.) will apply.

(b) TFSA's offered by Corporations Authorized to Act as Trustees

In general terms, investments that these trusts may hold include:

- ✓ Money and deposits
- ✓ Debt obligations issued by the federal government, by a provincial or municipal government or a crown corporation
- ✓ Debt obligations issued by a corporation, mutual fund trust or limited partnership, the shares of which are listed on a designated stock exchange in Canada
- ✓ Debt obligations issued by a corporation whose shares are listed on a designated stock exchange in a foreign country and certain debt obligations issued by an authorized foreign bank
- ✓ Most investment-grade debt obligations
- ✓ Securities (other than futures contracts and certain derivatives) listed on a designated stock exchange in Canada or a foreign country
- ✓ Guaranteed investment certificates issued by trust companies
- ✓ Segregated fund contracts<sup>30</sup>

Additional conditions have been imposed for annuity contracts issued by licensed annuities providers (e.g., segregated fund contracts and other annuity contracts) where these are held by the trust. First, the trust must be the only person (disregarding any subsequent transfer) who is or may be entitled to annuity payments under the trust. Second, the holder of the contract must have the right to surrender (i.e., commute) the contract at any time for an amount that would (if reasonable sales and administration charges were ignored) otherwise be applied to fund future periodic payments under the contract. This second required feature is an unusual feature. Since annuities are generally not commutable (with the exception of certain term fund contracts, etc.), trusts will be constrained in the types of annuities that they may acquire.

It is important to realize that annuity contracts may enjoy the advantages (e.g. creditor protection in some circumstances) that insurance contracts provide. Where these are held within a trust, this advantage may be lost. Thus, direct ownership may be the wiser choice.

Finally, "prescribed investments" may be held by the trust. We note that the Income Tax Act Regulations will have to be amended for certain other investments to be held by a TFSA trust. On July 14, 2008 Finance released draft regulations. With the release (and ultimately enactment) of the draft regulations, TFSA trusts will be able to invest in mutual fund trusts and mutual fund corporations.<sup>31</sup> With this amendment, TFSA trusts will be permitted to hold the same assets as RRSPs.

We note that these same regulations are being updated to permit investments in certain American Depository Receipts.<sup>32</sup>

<sup>30</sup> See definition of "qualified investment" in subsection 207.01(1) of the ITA. Also, see *Explanatory Notes related to the Income Tax Act, the Excise Act, the Excise Act, 2001, the Customs Tariff, the Excise Tax Act and other Acts* (Technical Notes), as issued by the Department of Finance in April 2008.

<sup>31</sup> See proposed subsection 4900(5) of the Income Tax Regulations (Regulations).

<sup>32</sup> See proposed paragraph 4900(1)(p.1) of the Regulations.

### (c) Prohibited Investments and Non-Qualified Investments

A TFSA trust should not acquire prohibited or non-qualified investments, as a penalty tax will arise where this is done. The penalty tax will also arise if the investment becomes prohibited or non-qualified.<sup>33</sup> This penalty tax is equal to 50% of the FMV of the property.<sup>34</sup> (This tax is recoverable where the assets are subsequently disposed.<sup>35</sup>)

There is an additional tax that applies on income earned (including capital gains) relating to prohibited and non-qualified investments.<sup>36</sup> (The tax rate applying here is that which would apply to income earned by an inter vivos trust.<sup>37</sup>)

While the ITA contains a detailed definition of “prohibited investments”, these are generally investments in entities with which the holder of the TFSA does not deal at arm’s length. Included here are entities in which the holder is a “specified shareholder”.<sup>38</sup>

Non-qualified investments are investments that do not meet the “qualified investment” definition.<sup>39</sup>

The TFSA trust issuer must “exercise the care, diligence and skill of a reasonably prudent person to minimize the possibility” that the trust holds non-qualified investments.”<sup>40</sup> CRA can waive the taxes where these arose because of a reasonable error.

## IV. Miscellaneous Provisions

### (a) Qualifying Transfers

Plan-to-plan transfers (i.e., “qualifying transfers”) are permitted in two circumstances.<sup>41</sup> First, between plans of the same holder. Here, a holder could transfer assets to another issuer, or could use the proceeds of one annuity contract (e.g., a segregated fund contract) to acquire another annuity contract (e.g., a term fund contract).

The second is a direct transfer upon marriage breakdown. Here, the individuals must be living separate and apart at the time of the transfer and must be made under a decree, order or judgment of a competent tribunal, or under a written separation agreement.

### (b) Death of Spouse Where Spouse is Successor Holder

Where a TFSA is issued, upon the death of the “holder”, a “survivor” (which we refer to as a “successor holder”) can succeed to the arrangement upon the death of the holder. However, only a person who was the spouse or common-law partner of the holder immediately prior to their death can be a “survivor”.<sup>42</sup> Children and other parties (e.g., siblings) cannot be successor holders.

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<sup>33</sup> See subsection 207.04 of the ITA.

<sup>34</sup> See subsection 207.04(2) of the ITA.

<sup>35</sup> See subsection 207.04(4) of the ITA.

<sup>36</sup> See subsections 207.04(6) and (7) of the ITA.

<sup>37</sup> See subsection 207.04(7) of the ITA.

<sup>38</sup> See definition of “prohibited investment” in subsection 207.1(1) of the ITA. The July 14, 2008 Draft Legislation contains a proposal to repeal the definition of “restricted property” contained in subsection 207.01(1) of the ITA.

<sup>39</sup> See definition of “non-qualified investment” in subsection 207.1(1) of the ITA.

<sup>40</sup> See subsection 207.01(5) of the ITA.

<sup>41</sup> See definition of “qualifying transfer” in subsection 207.01(1) of the ITA.

<sup>42</sup> See definition of “survivor” in subsection 146.2(1) of the ITA.

In this situation, the surviving spouse essentially steps into the shoes of the deceased spouse. We note that special rules apply where the deceased spouse had an “excess TFSA amount” immediately prior to his or her death.<sup>43</sup> (The calculation of the “excess TFSA amount” is discussed in (d) below.)

(c) Death of Spouse Where Spouse is a Beneficiary

Different rules apply where a spouse or common-law partner is not a successor holder and is a beneficiary of a trust, whether on a direct or indirect basis. The TFSA legislation, as originally enacted, contained cumbersome rules.

Under the legislation, as enacted, a spouse (or common-law partner) has a two-year “rollover period”. Let’s assume John dies July 1, 2013, at which time the FMV the assets in the TFSA is \$25,000. He has not designated his wife Susan as “successor holder”. Thus, TFSA status is lost upon John’s passing. Susan, however, is the beneficiary of his estate under his will. (Since TFSA status is lost as at John’s date of death, income earned after John’s death in the new trust that comes into being as at that date is taxable.<sup>44</sup>)

In John’s situation, the current rules provide for a two-year “rollover period” that would end on the second anniversary of his death (i.e., July 1, 2015.) Let’s assume that the assets grow, and Susan would ultimately receive a “survivor payment” of \$28,000 on September 15, 2014. Susan, in completing her tax return for 2014, would designate (in prescribed form) \$25,000 of the amount that she has received as an “exempt contribution”, and could contribute this amount to her own TFSA.<sup>45</sup> \$3,000 would be taxable to her at that time. (“Exempt contributions” do not affect TFSA room.)

Had John been in an excess contribution situation at his death, this excess would reduce the amount Susan could designate.<sup>46</sup>

The rules, as enacted, give CRA the discretion to extend the 2-year rollover period.

The draft legislation introduced on July 14, 2008 modifies the original rules and eliminates undue administrative and reporting difficulties for trusts. With the new rules, the tax-free status of a TFSA trust will continue until December 31<sup>st</sup> of the year following the death of the original holder.<sup>47</sup> (If the assets are still held by the trust it has a deemed disposition and reacquisition of its assets at then FMV at that time, and is taxable from that time on.<sup>48</sup>) CRA has also confirmed that where the TFSA still exists after this exempt period, a *T3 Income Tax and Information Return* needs to be filed for every year beyond the exempt period.<sup>49</sup>

When Susan receives the \$28,000 from the TFSA, she may have to include a portion of this payment in her income. The income inclusion will be the amount by which the distribution made to her exceeds the FMV of the assets of the trust immediately before the holder’s death.<sup>50</sup> CRA has indicated that this amount (\$3,000 in our example) is to be reported on a T4A slip as “other income”.<sup>51</sup> (The \$25,000 can of course be contributed to her own TFSA as an “exempt contribution”. Here, CRA is requiring that a prescribed form will have to be filed within 30 days of the contribution. The contributions will have to be made no later than December 31<sup>st</sup> of the year following the death.<sup>52</sup>)

<sup>43</sup> See subsection 207.01(3) of the ITA,

<sup>44</sup> See subsection 146.2(6) of the ITA. Renumbered as subsection 146.2(8) per the July 14, 2008 Draft Legislation.

<sup>45</sup> See definition of “exempt contribution” in subsection 207.01(2) of the ITA.

<sup>46</sup> See subsection 207.01(3) of the ITA.

<sup>47</sup> See proposed subsection 146.2(9) of the July 14, 2008 Draft Legislation.

<sup>48</sup> See proposed subsection 146.2(8) of the July 14, 2008 Draft Legislation.

<sup>49</sup> See item 7.2, as contained in the document entitled *Tax-Free Savings Accounts – Information for TFSA issuers*, as released by the Canada Revenue Agency (CRA) on August 26, 2008.

<sup>50</sup> See proposed paragraph 146.2(9)(b) of the July 14, 2008 Draft Legislation.

<sup>51</sup> See item 7.2, as contained in the document entitled *Tax-Free Savings Accounts – Information for TFSA issuers*, as released by the Canada Revenue Agency (CRA) on August 26, 2008.

<sup>52</sup> See item 7.3, as contained in the document entitled *Tax-Free Savings Accounts – Information for TFSA issuers*, as released by the Canada Revenue Agency (CRA) on August 26, 2008.

If Susan were a non-resident of Canada at the time she received the \$3,000, non-resident withholding taxes would have to be withheld on this amount.<sup>53</sup> Where Susan is a non-resident, the \$25,000 should not be contributed to her own TFSA, as this would attract the 1% per month penalty tax (see **Section IV, part (I).**)

(d) Penalties Applying on Excess Contributions to TFSAs

Where the cumulative amount contributed to all of the TFSAs of an individual are in excess of the limit, a 1% per month penalty will apply. This is calculated with respect to the highest “excess TFSA amount” in that month.<sup>54</sup> The penalties can be waived where CRA is satisfied that the excess arose because of a reasonable error and where the amounts are withdrawn without delay.<sup>55</sup>

The “excess TFSA amount” is calculated as:

A – B – C – D – E, where

- A = Total amount of TFSA contributions made in the year before that time, except for “exempt contributions” and “qualifying transfers”
- B = The individual's “unused TFSA contribution room” at the end of the prior year
- C = Distributions from the individual's TFSAs in the preceding year, other than a “qualifying transfer “ or a “prescribed distribution”
- D = “TFSA dollar limit” for the year where at any time in the year the individual was resident in Canada
- E = Total distributions made in the year before that time, except for a “qualifying transfer” or “prescribed distribution”

When we look at variable A, we see that exempt contributions and qualifying transfers are excluded in the calculation. For a discussion of variable B, see **Section II part (f).**

When we look at variable C, we see that the effect is to allow individuals who withdrew amounts from their TFSA to recontribute the amount in its entirety in a subsequent year. Thus, the TFSA can be replenished. When we look at distributions, we do not distinguish between income (including capital gains) and original contributions. The gross amount withdrawn from the TFSA may be recontributed in a subsequent year.) If a person had unused TFSA room in the year of the withdrawal, the amount could in fact be recontributed in the same year to the extent of the unused room.

For a discussion of variable D, see **Section II part (e).**

In variable E, “prescribed distributions” are deducted in arriving at “total distributions”. Here let's assume that a person withdraws \$7,500 from the TFSA, with only \$2,000 (the “prescribed distribution”) being required to eliminate any “excess TFSA amount”. In this example, variable E would be equal to \$5,500.<sup>56</sup>

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<sup>53</sup> See item 8.3, as contained in the document entitled *Tax-Free Savings Accounts – Information for TFSA issuers*, as released by the Canada Revenue Agency (CRA) on August 26, 2008.

<sup>54</sup> See section 207.02 of the ITA,

<sup>55</sup> See section 207.06 of the ITA.

<sup>56</sup> See proposed revision to variable E per the July 14, 2008 Draft Legislation.

(e) Fees

Fees payable in respect of TFSAs are not deductible for tax purposes.<sup>57</sup> As stated by Finance, both administration fees and investment counseling fees are non-deductible.<sup>58</sup>

(f) Interest

Interest on funds borrowed to make TFSA contributions is not deductible for tax purposes.<sup>59</sup> Investors will need to take care in structuring investment loans so as to ensure that the proceeds are used for the appropriate purposes. (For a discussion of interest deductibility, readers may wish to refer to *Interest Deductibility* [PC 6141].)

(g) Superficial Loss Rules

A taxpayer may make a contribution in kind to a TFSA. A taxpayer is considered to have a disposition for tax purposes where he or she makes such a contribution. Any capital loss realized where a taxpayer makes a contribution to a trust under which he or she is the beneficiary (i.e., holder) will be disallowed.<sup>60</sup> Thus holders should not make in-kind contributions of assets having accrued capital losses.

(h) Attribution Rules

A spouse (or common-law partner, including a same-sex partner) may make a contribution to their spouse's (or common-law partner's) TFSA. The rules specifically provide that the investment income earned by the TFSA is not attributed back to the contributor so long as: (1) the property (or substituted property) remains in the TFSA, and (2) to the extent that the spouse (common-law partner) to whose plan the contribution was made had the available TFSA room.<sup>61</sup>

The ITA also contains special attribution rules for property contributed to a trust where the contributed property can revert to that person (or to other persons determined by that person). These provisions have been amended to provide that these rules do not apply to property held by a TFSA trust.<sup>62</sup>

(i) Trust-to-Trust Transfers

A TFSA trust will be permitted to transfer assets to another TFSA trust on a tax-deferred basis, provided that there is no change in beneficial ownership of the property.<sup>63</sup>

(j) 21-Year Rule for Trusts

TFSA trusts are exempted from the 21-year deemed disposition rule.<sup>64</sup>

(k) Designation

The new legislation allows the holder of a TFSA to designate a charity as the beneficiary of the TFSA, except where the arrangement is one for which a licensed annuities provider is the issuer or carrier. (Where there is a designation of beneficiary in a contract issued by a licensed annuity provider (e.g., a segregated fund contract, an annuities contract, etc.), the existing provisions of the ITA dealing with donations of life insurance policies will automatically apply.<sup>65</sup>)

<sup>57</sup> See paragraph 18(1)(u) of the ITA.

<sup>58</sup> See discussion of paragraph 18(1)(u) in *Explanatory Notes to the Income Tax Act, the Excise Act, the Excise Act, 2001, the Customs Tariff, the Excise Tax Act and other Acts* (Explanatory Notes), as released by Finance in April 2008.

<sup>59</sup> See subsection 18(11) of the ITA.

<sup>60</sup> See clause 40(2)(g)(iv)(A) of the ITA.

<sup>61</sup> See paragraph 74.5(12)(c) of the ITA.

<sup>62</sup> See paragraph 75(3)(a) of the ITA.

<sup>63</sup> See subsection 107.4(1) of the ITA.

<sup>64</sup> See subsection 108(1) of the ITA.

<sup>65</sup> See subsections 118.1(5.1) and (5.2) of the ITA.

Thus, upon the death of the holder, the holder of any TFSA for which there is a designation of beneficiary will be considered to have made a donation to the charity in the year of death.<sup>66</sup> Thus, the donor will be able to claim the appropriate tax credits for this donation on the terminal tax return (or on the tax return for the year preceding death).<sup>67</sup>

(l) Ceasing to be Resident of Canada

Specific tax rules in the ITA deem that persons immigrating to or emigrating from Canada are deemed to dispose of (and immediately reacquire) certain assets. These provisions have been amended to clarify that a beneficiary of a TFSA is not subject to these rules, as a right under a TFSA will be considered to be an “excluded right or interest”.<sup>68</sup>

Contributions should not be made to the TFSA while an individual is a non-resident, even if the person had accrued contribution room prior to leaving Canada. A 1% per month penalty applies until these contributions are withdrawn from the TFSA, or until the person again becomes a resident of Canada.<sup>69</sup> The penalty tax may be waived if it arose because of a reasonable error and non-resident contributions are withdrawn without delay.<sup>70</sup>

(m) Using TFSA as Security for a Loan

A TFSA may be used as security for a loan. The draft legislation that was released on July 14, 2008 contains rules to prevent the “sale” or “rental” of TFSA room. In order to prevent others from benefiting from the tax-exempt earnings of the TFSA, TFSA status will only be maintained where the loan is on an arm’s-length basis and it is reasonable to conclude that none of the main purposes of the loan was to allow a person other than the holder (or a partnership) from benefiting from the tax exempt status of the TFSA.<sup>71</sup>

(n) Death of a Holder of a TFSA Issued Under an Annuity Contract

The legislation governing TFSAs on death does not adequately address the features of an annuity contract. For example, absent a successor annuitant designation, such contracts cease immediately on death so that provisions granting tax free status of a TFSA trust after the death of a holder cannot apply. This becomes cumbersome, given the deemed disposition at the time of death (and thus the no longer tax-free status of subsequent investment income and capital gain). With the delays associated with when licensed annuities issuers would actually be notified of a death, compliance becomes extremely difficult. We understand that the insurance industry has made representations to Finance in order to ensure that such contracts receive treatment that is equivalent to that accorded to trusts.

## V. Summary

TFSAs are tax-efficient arrangements destined to become important the financial planning tools available to Canadian taxpayers. Their arrival as at January 1, 2009 is much anticipated.

Financial advisors will want to make sure that they can provide the appropriate advice to clients, including helping clients select which arrangement best serves their needs (for example, deciding when to contribute to a Registered Retirement Savings Plan as opposed to a TFSA). We anticipate issuing additional items in this series, which will provide some insight here.

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<sup>66</sup> See subsection 118.1(5.3) of the ITA.

<sup>67</sup> See subsection 118.1(4) of the ITA.

<sup>68</sup> See subsection 128.1(10) of the ITA.

<sup>69</sup> See section 207.03 of the ITA.

<sup>70</sup> See section 207.06 of the ITA.

<sup>71</sup> See proposed subsection 146.2(3) and (4) of the July 14, 2008 Draft Legislation.

For more background information, please refer to **The Proposed Tax-Free Savings Account** [PC 6303], which reviews the proposals relating to the Tax-Free Savings Account (TFSA) that were contained in the 2008 Federal Budget. This legislation received Royal Assent on June 18, 2008. On July 14, 2008, the Department of Finance (Finance) released draft legislation, which deals with omissions in the earlier legislation.<sup>72</sup> This legislation still needs to be tabled in Parliament.

*This document is intended for general information only. It should not be construed as legal, accounting, tax or specific investment advice. Clients should consult a professional advisor concerning their situations and any specific investment matters. While reasonable steps have been taken to ensure that this information was accurate as of the date hereof, The Standard Life Assurance Company of Canada and its affiliates make no representation or warranty as to the accuracy of this information and we assume no responsibility for reliance upon it.*

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<sup>72</sup> See Department of Finance Release # 2008-054: Government of Canada Moves to Implement Outstanding Tax Measures dated July 14, 2008, including *Legislative Proposals and Explanatory Notes relating to the Income Tax Act, the Excise Act, 2001 and the Excise Tax Act* (Draft Legislation).