Canadian Tax Free Savings Accounts – Canada Revenue Agency Audit Project

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As we have previously written, the Canada Revenue Agency ("CRA") is aggressively reviewing certain Tax Free Savings Accounts ("TFSAs"). Subsection 146.2(6) of the Canadian Income Tax Act provides that if a TFSA "*carries on one or more businesses,*" then Part I tax is payable on its business income. This provision, little noticed until recently, has been the basis for a wave of CRA tax assessments issued to TFSAs in respect of income allegedly earned from carrying on a securities trading business inside the TFSA. Generally, the assessments are issued to TFSAs with high balances whose annuitants are investment advisors or have significant knowledge and experience in the securities industry, particularly (but not always) where the TFSA has traded frequently in speculative stocks. There is usually no limitation period for the CRA to assess because TFSAs generally do not file a tax return under Part I of the Act.

In Technical interpretation 2014-05382211C6 (October 10, 2014) (available only in French), the CRA confirmed its position that "speculative transactions" carried on by an RRSP, RRIF, or TFSA may amount to the operation of a business by the deferred plan, resulting in the income from such business being subject to income tax. The CRA has yet to publish guidelines on what is meant by "carrying on business" in relation to these kinds of plans, but the factors used in recent TFSA audits are the same as those listed in paragraph 11 of archived CRA Interpretation Bulletin IT-479R ("Transactions in Securities," February 29, 1984): frequency of transactions, period of ownership, knowledge of securities markets, security transactions forming a part of the taxpayer's ordinary business, time spent, advertising, and the speculative nature of the securities involved. The CRA's audit project does not appear to be restricted to TFSAs engaged in day trading.

We believe the CRA's interpretation is ill-founded. In *Prochuk v. The Queen*, the taxpayer supported himself for years on withdrawals from his RRSP, in which he regularly traded with apparent success. In 2007, he realized a significant loss on an investment outside his RRSP. In attempting to deduct his loss on income account, the taxpayer argued that the trading conducted in his RRSP should be considered because it would provide evidence that he was in the business of trading. The CRA argued that trading securities in an RRSP is not carrying on a business, citing *Deep v. The Queen*. D'Auray J. agreed that trading in an RRSP does not amount to carrying on a business. This decision runs counter to the CRA's position in its current audit project on TFSAs. However, as stated in the TI, the CRA appears to be limiting the case to its particular facts. We believe the principles enunciated in *Prochuk* and *Deep* should apply equally to TFSAs.

Interestingly, legislation involving accounts similar to TFSAs in other countries also renders income from carrying on a business taxable. In the United States, the analogous account is the Roth individual retirement account, for which income earned from an unrelated business is not exempted (see Code sections 408(e)(1), 511(a)(1), and 511(b)(1) and (2)). In the United Kingdom, the analogous account is the individual savings account, for which income from carrying on a business is not exempted (see section 22 of the Individual Savings Account Regulations 1998). However, we understand that neither the US nor the UK tax authorities have adopted an interpretation similar to the CRA's position on the

taxation of TFSAs trading in securities. In other words, income earned from speculative trading in qualifying securities is exempt notwithstanding the prohibition against carrying on business.

We have been retained by several taxpayers to dispute such reassessments by filing notices of objection and in at one least case, to file and pursue an appeal in the Tax Court of Canada. We believe the legislation should be interpreted such that trading qualifying securities not be considered “carrying on business” by a TFSA no matter how frequently the TFSA has traded nor how speculative the underlying securities may be. This provides a so-called “bright line” test which reduces the uncertainty regarding the taxability or non-taxability of TFSAs.

If you have a TFSA that has been traded frequently, then be prepared for an audit or challenge by the CRA. Taxpayers who have already been selected for audit by the CRA should seek competent professional advice.