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BUDGET 2015: TAX-FREE SAVINGS ACCOUNTS – A WELCOME CONTRIBUTION LIMIT INCREASE, BUT "PROHIBITED INVESTMENT" RULES REMAIN A CONCERN

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The Tax-Free Savings Account ("**TFSA**") is a flexible, registered, savings vehicle that allows Canadians to earn tax-free investment income. Originally introduced in 2009, the TFSA complements traditional registered savings plans, such as Registered Retirement Savings Plans ("**RRSPs**") and Registered Education Savings Plans ("**RESPs**"). In contrast to RRSPs, TFSA contributions are not tax deductible; however, withdrawals need not be included in the holder's income.

Budget 2015 proposes to increase the TFSA annual contribution limit from $5,500 to $10,000, with effect from January 1, 2015. The TFSA annual contribution limit will no longer be indexed to inflation.

Unfortunately, Budget 2015 contained no changes with respect to the so called "prohibited investment" rules ("**Prohibited Investment Rules**"), which serve to restrict the scope of investments for TFSA purposes, and which continue to present potential traps for the unwary, including, for example, investment fund managers seeking to hold units of the funds they manage.

Prohibited Investment Rule Overview

In very general terms, a "prohibited investment" in respect of a TFSA (as well as certain other registered plans such as RRSPs) is defined in subsection 207.01(1) of the *Income Tax Act* (Canada) (the "**Tax Act**") to include:

a. a debt of the TFSA holder (other than certain insured mortgages);[1]
b. a share or debt of, or interest in, a corporation, trust or partnership in which the TFSA holder has a "significant interest";
c. a share or debt of, or an interest in, a person or partnership with which the TFSA holder does not deal at "arm's length" (the "**Arm's Length Test**");
d. an interest in, or right to acquire, a share, interest or debt described in paragraphs (a) through (c) above; and
e. certain "prescribed property".

A key factor in determining whether an investment by a TFSA in a particular entity is a "prohibited investment" is whether the holder of the TFSA is considered to have a "significant interest" in the particular entity.

Generally, an individual will have a "significant interest" in a trust or partnership if she, either alone or together with persons or partnerships with whom she does not deal at "arm's length", holds interests as a member of the partnership or as a beneficiary under the trust that have a fair market value of 10% or more of the fair market value of the interests of all members of the partnership or beneficiaries under the trust, respectively.

An individual will be considered to have a "significant interest" in a corporation if she is a "specified shareholder"[2] of the corporation. Generally, a person is considered to be a specified shareholder of a corporation if she owns, directly or indirectly, at any time in the relevant year, 10% or more of the issued shares of any class of the capital stock of the corporation or of any other corporation that is "related" to the corporation.[3]

Penalty Regime

Under section 207.04, a TFSA holder will be liable for a penalty tax where his TFSA acquires a property that is a "prohibited investment" (or where property held by the TFSA becomes a "prohibited investment"). The penalty tax is equal to 50% of the fair market value of the prohibited investment at the time it is acquired (or at the time the subject property becomes a "prohibited investment") and is refundable if the "prohibited investment" is disposed of by the TFSA by the end of the year following the year in which the tax applied or such later time as the Minister of National Revenue (the "**Minister**") determines, unless it is reasonable to consider that the holder knew, or ought to have known, at the time the investment was acquired by the TFSA, that it was, or would become, a prohibited investment.[4] Furthermore, the Minister is granted the discretion, under subsection 207.06(2), to waive this penalty tax where it is "just and equitable to do so" having regard to all the circumstances, including (i) whether the penalty tax arose as a consequence of reasonable error, or (ii) the extent to which the transaction in question that gave rise to the penalty tax also gave rise to another tax under Part XI.01 of the Tax Act.[5]

In addition to the penalty tax discussed above, any income (including capital gains) derived, directly or indirectly by a TFSA in respect of the "prohibited investment" will be considered an "advantage"[6] in relation to the TFSA, and will subject the relevant holder to a penalty tax equal to 100% of the value of that "advantage".[7] Once again, the Minister is authorized, under subsection 207.06(2), to waive this penalty tax where it is "just and equitable to do so".

Continuing Concerns with Prohibited Investment Rules

A number of concerns have been raised over the years with respect to the application of the Prohibited

Investment Rules to TFSAs, including the ambit of the "prohibited investment" definition, along with uncertainties associated with the application of the Non Arm's Length Test.[8]

For instance, in determining whether a particular individual has a "significant interest" in any entity, it is necessary to look not only at the investment assets held by the particular individual, but also to investments held by any person who, for purposes of the Tax Act, does not deal, or is deemed not to deal, at "arm's length" with the individual. Accordingly, it is possible that an individual could unknowingly hold a "significant interest" in an entity as a result, for example, of the holdings of other family members, family trusts, or personal holding companies. Indeed, this could be the case in circumstances where the holdings in the TFSA are exceptionally modest or where the holder has little direct connection to the subject entity.

The ambit of the "prohibited investment" definition is further expanded by the Arm's Length Test. While the application of the Arm's Length Test may be relatively straightforward with respect to TFSA holders who are deemed, for purposes of the Tax Act, to be "related" to a particular entity (and therefore not to deal at arm's length with the particular entity),[9] the application of the test becomes trickier when considering whether a TFSA holder, in fact, deals at arm's length with the particular entity for the purposes of paragraph 251(1)(c). This type of factual analysis may arise, for instance, in respect of TFSA holders who act as officers or directors of a corporation and who wish to hold shares of the corporation in their TFSA (or other registered savings plans). Another example in the investment fund context would be where an advisory agreement gives a fund manager significant decision making powers with respect to the day-to-day operations of the fund. Although it will, in many cases, be difficult for the Canada Revenue Agency to successfully assert that such situations in and of themselves give rise to a non arm's length relationship, such a determination is ultimately a question of fact and may be a matter of some uncertainty, even in cases where the shareholdings or partnership holdings (as the case may be) are minimal.

Conclusions

While the TFSA contribution limit increase announced in Budget 2015 is clearly a welcome development, taxpayers should continue to be mindful of the potential restrictions and challenges posed by the Prohibited Investment Rules, which are complex and may give rise to punitive taxes and penalties in unexpected circumstances.

by Todd A. Miller

[1][ps2id id='1' target=''/] Section 5000 and paragraph 4900(1)(j.1) of the *Income Tax Regulations* (the "**Regulations**") provide an exemption for certain insured debt obligations (or interests therein) secured by mortgages in respect of real property situated in Canada.

[2][ps2id id='2' target=''/] As defined in subsection 248(1).

[3][ps2id id='3' target=''/] For this purpose, a particular person is deemed to own (i) all of the shares of any corporation owned by persons with whom he/she does not deal at arm's length, and (ii) a portion of any shares owned by a trust or partnership in which the particular person has an interest, based on the relative fair market value of the particular person's proportionate interest in the trust or partnership (except where the trust is a discretionary trust, in which case the particular person is deemed to own all of the shares of the corporation owned by the trust). In addition, in some circumstances, a person can be deemed to be a "specified shareholder" of a corporation where he/she performs certain services on behalf of the corporation – see paragraph (d) of the definition of a "specified shareholder" in subsection 248(1).

[4][ps2id id='4' target=''/] Subsections 207.04(2) and (4).

[5][ps2id id='5' target=''/] A Canada Revenue Agency ("CRA") technical interpretation letter (CRA Document No. 2011 0430141E5, dated February 3, 2012) provides examples of circumstances in which the CRA will consider waiving the penalty tax and contains a statement of the CRA's intention to "administer the waiver proposition in a fair and flexible manner in order to promote voluntary compliance".

[6][ps2id id='6' target=''/] As defined in subsection 207.01(1).

[7][ps2id id='7' target=''/] Section 207.05.

[8][ps2id id='8' target=''/] In contrast to the relatively "bright line" requirements of the "significant interest" definition.

[9][ps2id id='9' target=''/] For example, by virtue of subsection 251(2).

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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