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The CRA is actively looking for people who day trade investments in their TFSAs

Jamie Golombek: Unlike an RRSP, a TFSA is not exempt from paying tax on business income from day trading

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A TFSA is generally exempt from tax on its income, subject to two exceptions: the TFSA holds non-qualified investments or it carries on as a business. PHOTO BY BRENDAN MCDERMID/REUTERS

If you actively trade marketable securities in your tax-free savings account, you may be surprised to learn that this activity could constitute a business, and the TFSA, rather than being tax free, could be subject to tax on its business income.

In the past few years, active trading in a TFSA has been a focus area for the Canada Revenue Agency's audit and reassessment activities, and the agency has been targeting taxpayers who actively trade securities in their TFSAs. A tax case decided earlier this month involved a taxpayer who grew his TFSA to more than $617,000 from $15,000 in three years by actively trading penny stocks.

The taxpayer, a Vancouver-based investment adviser, opened his first TFSA at the very beginning of the program's launch on Jan. 2, 2009. It was a self-directed TFSA, and all securities purchased and sold by the TFSA were "qualified investments," as stipulated by the Income Tax Act.

Common types of qualified investments include: money, guaranteed investment certificates and other deposits, most securities listed on a designated stock exchange such as shares of corporations, warrants and options, and units of exchange-traded funds, real estate investment trusts, mutual funds and segregated funds, debt obligations of a corporation listed on a designated stock exchange, and debt obligations that have an investment-grade rating. The CRA maintains a comprehensive list of qualified investments in its Folio S3-F10-C1, Qualified Investments — RRSPs, RESPs, RRIFs, RDSPs and TFSAs.

Most of the taxpayer's TFSA investments were non-dividend paying and speculative in nature, with the majority being junior mining penny stocks listed on the TSX Venture Exchange. The taxpayer's TFSA held most of the shares for only brief periods of time.

The taxpayer contributed the maximum allowable contributions of $5,000 to his TFSA in early January in each of 2009, 2010 and 2011. By Dec. 31, 2011, his TFSA had grown to a fair market value of $617,371. By the end of 2012, the TFSA's market value had dropped to $564,483. Shortly thereafter, in January 2013, the taxpayer liquidated the securities in his TFSA, and transferred proceeds of nearly $547,800 to himself on a tax-free basis.

The CRA reassessed the taxpayer's TFSA for each of the 2009, 2010, 2011 and 2012 taxation years on the basis that the TFSA carried on a business of trading qualified investments in each of those years and, therefore, the income from carrying on that business during each of those years was subject to income tax. The tax assessed was based on taxable income of $44,270 in 2009, $180,190 in 2010, $330,994 in 2011 and $14,027 in 2012.

The CRA considers a variety of factors when determining whether a taxpayer's gains from securities constitute carrying on a business, including the frequency of the transactions, the duration of the holdings, the intention to acquire securities for resale at a profit, the nature and quantity of the securities, and the time spent on the activity.

The CRA has been targeting taxpayers who actively trade securities in their TFSAs
PHOTO BY GETTY IMAGES/ISTOCKPHOTO

The judge said there was no doubt that the taxpayer was conducting an active trading business in his TFSA based on his trading activity. The consequence of doing so is clearly spelled out in the Income Tax Act, which states that a TFSA is generally exempt from tax on its income, subject to two exceptions: the TFSA holds non-qualified investments or it carries on as a business. If either exception applies, then tax is payable by the TFSA on its taxable income.

This rule is in direct contrast to the rules governing active trading in a registered retirement savings plan (RRSP) or registered retirement income fund (RRIF). The Income Tax Act has a specific rule that exempts both RRSPs and RRIFs from paying tax on business income when that income is derived from investing in qualified investments.

"This means … that if an RRSP or RRIF were to engage in the business of day trading of various securities, it would not be taxable on the income derived from that business provided that the trading activities were limited to the buying and selling of qualified investments," the CRA states in its folio on qualified investments.

The crux of the taxpayer's argument was that the rule that exempts an RRSP from paying tax on business income from active trading of qualified investments ought to be applied to a TFSA as well. He argued "there could have been no legislative purpose for making a TFSA … taxable on the income from carrying on a business of trading qualified investments when an RRSP carrying on the very same business is not taxable."

In response, the judge noted that Parliament deliberately chose not to make the TFSA regime the same as the RRSP regime when it comes to business income in the plans. "Had Parliament also intended to exempt from tax a TFSA's income from carrying on a particular type of business — trading qualified investments — Parliament would have legislated accordingly, just as it had for RRSPs," he wrote.

The judge said the TFSA was designed to allow Canadians to increase their savings by earning tax-free investment income such as capital gains, interest and dividends, but not to enable the carrying on of business, such as active trading, tax free.

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The judge then went through a list of 10 ways in which RRSPs and TFSAs are different, including: age requirements (you must be 18 to set up a TFSA); terminal age (RRSPs must end by age 71); contribution eligibility (you must have earned income to contribute to an RRSP); TFSA withdrawals may be recontributed the following year; and withdrawals from an RRSP may affect the taxpayer's entitlement to income-tested benefits and tax credits, while TFSA withdrawals do not. These differences all show the rules governing RRSPs and TFSAs are simply not the same.

The judge concluded it was clear the taxpayer — a professional investor with deep knowledge and experience in the securities market, who traded frequently, buying and selling shares that were mostly speculative in nature and owning them for short periods — was carrying on an active trading business in his TFSA. As a result, the TFSA should be taxable on its income in 2009, 2010, 2011 and 2012.

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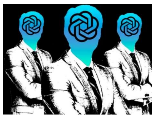
5 

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