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Rethink deliberate TFSA overcontributions

The TFSA annual contribution limit (also referred to as the TFSA dollar limit) has increased for 2019. The limit is now $6,000, up from $5,500 in 2018. With the increase, the cumulative amount a Canadian-resident individual can contribute to his/her TFSA in 2019 (assuming the individual was age 18 or older in 2009 and has never contributed to a TFSA) is $63,500. Below is a summary of historical TFSA annual and cumulative contribution limits.

TFSA annual and cumulative contribution limits*		
Year	Annual limit	Cumulative limit
2009	$5,000	$5,000
2010	$5,000	$10,000
2011	$5,000	$15,000
2012	$5,000	$20,000
2013	$5,500	$25,500
2014	$5,500	$31,000
2015	$10,000	$41,000
2016	$5,500	$46,500
2017	$5,500	$52,000
2018	$5,500	$57,500
2019	$6,000	$63,500

*Assumes individual was 18 years of age or older in 2009 and a resident of Canada for each year since then.

Despite these limits, TFSA overcontributions (also known as excess contributions) occur. When they do, a 1% per month overcontribution penalty tax applies until the excess amount is withdrawn or new contribution room becomes available. For more information, see CI's "TFSA Overcontributions – When They Occur and How to Fix Them" article.

Sometimes overcontributions are the result of a reasonable error; other times they are more deliberate. Consider the following scenario.

Early in 2019, as per her contribution limit, Jessica contributed the maximum amount to her TFSA. On March 1, wanting to further benefit from the tax-free status of the account, she deliberately contributed another $10K – an excess contribution – which she invested in a "hot stock" that quickly produced a $2,000 profit within the account. On March 25, Jessica withdrew the $10K excess contribution hoping to both keep her $2,000 profit and avoid the 1% per month excess contribution penalty tax.

Initially, this strategy might sound like a great way to maximize profits and avoid tax. However, it is important to note, shortly after the introduction of the TFSA in 2009, the Department of Finance introduced rules designed to prevent this type of gaming with the TFSA. Consequently, not only would Jessica not avoid the 1% per month excess contributions penalty tax, but she would also be subject to a 100% advantage tax in respect of her profit from the deliberate overcontribution. Here's why:

Excess contribution tax

Deliberate or not, excess contributions are subject to a 1% per month penalty for each month the excess contribution remains outstanding. The penalty, which is based on the "highest excess TFSA amount" for the month, ceases when the excess amount is removed from the TFSA or when new TFSA contribution room becomes available in the following year. Even though Jessica removed her $10K excess amount before the end of March – the month in which she made the excess contribution – her highest excess amount for March was $10K. This resulted in a $100 penalty (1% X $10,000) for that month. The penalty would be due by June 30 of the year following the year in which the penalty arose. It would be calculated and reported using Canada Revenue Agency (CRA) form RC243, Tax-Free Savings Account (TFSA) Return.

Deliberate overcontribution "advantage" tax

In 2010 (and retroactive to October 2009), the Department of Finance introduced changes to the Income Tax Act (ITA) that address deliberate overcontributions to TFSAs. In brief, in addition to the 1% per month excess contribution penalty tax, income and capital gains reasonably attributable to deliberate overcontributions are subject to a 100% advantage tax in respect of the income. So, in Jessica's case, in addition to the $100 excess contribution penalty for March, she would also face a $2,000 advantage tax, wiping out her profit and the benefit of the strategy. The advantage tax would be due by June 30 of the year following the year the penalty arose and would be calculated and reported using CRA form RC243, Tax-Free Savings Account (TFSA) Return.

Interestingly, it does not appear that a similar advantage tax applies in respect of deliberate overcontributions to RRSPs; although, for RRSP overcontributions that exceed $2,000, the 1% per month penalty tax applies until such overcontributions are withdrawn (or new room becomes available).

CRA relief?

In theory, under the ITA, the CRA has authority to waive or cancel all or part of the above penalty taxes where appropriate. In determining eligibility for relief, the CRA will look to determine if the liability arose due to "reasonable error" and the promptness with which the error is corrected. With deliberate overcontributions, this relief might be difficult to obtain as taxpayers may have difficulty demonstrating "reasonable error". Regardless, taxpayers can request waiver or cancellation relief by sending a letter to the CRA with information that includes:

- The amount for which a waiver is requested;
- A description of the investment and income that gave rise to the tax; and
- A history of events including measures taken to resolve the non-compliance.

The TFSA is a flexible, general-purpose account designed to provide tax-free investment income. In most cases, it meets this objective. However, where deliberate overcontributions increase access to tax-free growth, the taxman has tools available to frustrate the strategy.

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