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COMMENT

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THE NEW KID ON THE BLOCK

Tax-Free Savings Accounts (TFSAs) are Canada's newest registered savings vehicle. Designed with a great deal of flexibility, they allow for both the accumulation and withdrawal of contributions and income. Beginning in 2009, an individual could contribute up to $5,000 annually into the plan for each of 2009 to 2012 inclusive, and $5,500 per year thereafter. While contributions are not tax deductible, all earnings within the plan grow tax–free, and funds can be withdrawn without tax consequences. Withdrawn amounts may be re-contributed in a subsequent year.

The decision to begin a TFSA is generally quite easy. Individuals can accumulate funds and avoid tax on the associated investment income. Compounding investment income without annual taxation provides a significant improvement in long-term savings potential. Let's look at a series of alternatives, each setting aside the same amount of funds annually at the beginning of each year.

Example One

» $5,000 invested annually in a non-registered interest-bearing account for a 10-year period, earning five per cent per year and subject to a 45 per cent effective annual tax rate, would accumulate to approximately $58,222 at the end of 10 years. Income taxes paid would total about $6,727 over the 10-year period.

» $5,000 invested annually in an interest-bearing product within a TFSA for a 10-year period, earning five per cent annually, would accumulate to about $66,034 at the end of the 10 years. As the TFSA account is not subject to taxation, there is no tax drain on the accumulation leaving more funds in the account on which to accumulate earnings.

In this example, the TFSA option (B) generated $7,812 more in overall accumulations when compared with a simple non-registered alternative (A). The higher overall accumulation arises from a combination of tax savings and compound interest thereon.

Example Two

» $5,000 invested annually in a non-registered investment, with capital appreciation compounding at five per cent annually for 10 years. At the end of year 10, the fund value is approximately $62,426 assuming the tax consequences are realized at the end of the 10-year period.

» $5,000 invested annually in a TFSA that holds only assets with capital appreciation compounding at five per cent annually. As in Example One B above, at the end of year 10 the fund value is about $66,034.

In Example Two, there is a smaller economic benefit of $3,608 for the individual using a TFSA ($66,034 minus $62,426).

Comparing examples one and two, the benefit of using a TFSA decreased in the capital gains example because taxation is deferred and the effective tax rate applicable to capital gains is less than for pure interest income. The magnitude of the compounding can accelerate if investments are held in products with higher growth potential such as stocks with significant capital appreciation.

The above analysis assumes that an individual already holds non-registered investments or has excess income on hand which is not needed for daily lifestyle. A TFSA provides a viable option that outperforms a simple non-registered investment. The types of investment earnings are worthy of consideration when deciding how to diversify personal holdings and incorporate a TFSA into the mix.

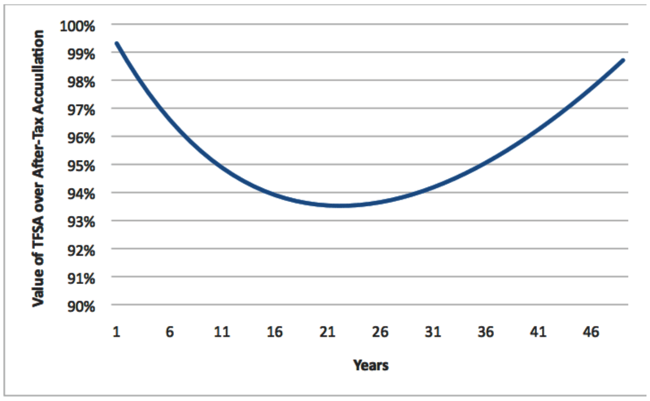
Personal circumstances should be considered in any analysis. If, for example, an individual is an incorporated professional or the owner of a private business, a more detailed analysis becomes valuable in assessing the alternatives. The need for more intricacy arises because the individual is a shareholder who pays tax on funds withdrawn from the company before they can be set aside into a TFSA. Shareholders of private companies often have an additional option to consider in respect of where to accumulate funds; the money could remain within the company and be paid out later, or a dividend could be paid currently and the after-tax proceeds deposited into a TFSA.

Consider the following example with a sole shareholder whose salary is fully used to meet lifestyle needs. Any TFSA contribution would require a larger amount to be withdrawn annually from the company so that appropriate taxes could be paid prior to netting the target contribution amount. In the example below, the investment is assumed to be a one-time $5,000 deposit in an equity portfolio that realizes an annual capital gain of three per cent.

	High-Taxed Province	Low-Taxed Province
Top marginal tax rate on ineligible dividends	40.13%	29.36%
Required dividend to net $5,000 (i.e., TFSA deposit)	$8,351	$7,078
Corporate accumulation at end of 10 years (annual realized capital gain of three per cent)	$10,491	$8,911
plus refundable dividend tax account on hand	$371	$315
plus capital dividend account	$1,391	$1,180
After-tax position of the shareholder if accumulation paid as dividend	$7,062	$6,864
Value of the TFSA under similar assumptions	$6,720	$6,720

In this comparison, the analysis assumes the shareholder is taxed at the highest marginal rate. For simplicity, the comparison looks at two extremes — an individual who is taxed in the province with the highest provincial tax rates, and another who is taxed at the lowest provincial rate. The provincial tax rates under these two scenarios are combined with the federal rates to derive a combined tax rate.

The following graph depicts the TFSA disadvantage under the specific set of assumptions outlined in this example. The curve is the value of the TFSA at the end of every year divided by the net after-tax value to the shareholder of corporate accumulations at the end of the corresponding year. For example, in year ten, the point on the curve is 95.16 per cent ($6,720 ÷ $7,062). The difference between the TFSA and corporate accumulations increases over time, and then the corporate advantage shrinks over time. Some of the change in advantage can be attributed to the time value of money on the refundable taxes paid by the company, and not refunded until a taxable dividend is paid.



The permutations and combinations can be limitless. The example used here is simply a starting point to demonstrate the type of analysis required. The variables in such an analysis include the individual's marginal effective tax rate on dividends at the time of accumulation and at the time of withdrawal, the type of investment income earned in the corporation, and the corporation's effective tax rates. Other considerations could include the impact of passive accumulations on the shares' ability to qualify for the capital gains exemption. As well, there are other considerations such as the flexibility of making withdrawals and re-deposits under the TFSA, and the exposure to creditors of the corporation with the corporate accumulation.

Planning involves knowing the choices available and taking the time to determine the best course of action under the circumstances.

I/R 7401.00

Managing the Risk of a Punitive Outcome

The Canada Revenue Agency (CRA) provides the opportunity to mitigate punitive income tax consequences arising from a miscalculation of the fair market value on a transaction when the parties incorporate a valid price adjustment clause (PAC). In general terms, a PAC is a clause in an agreement entered into by non-arm's-length parties that provides a mechanism to adjust the fair market value of the property should the CRA or courts of law disagree with the original valuation.

Non-arm's-length parties generally include the spouse of an individual taxpayer and the taxpayer's direct ascendants and descendants, along with the taxpayer's siblings. Spouses of the taxpayer's direct ascendants, descendants and siblings are typically included in this group. For example, assume Martin is the taxpayer. Martin's spouse along with his children, grandchildren, parents, grandparents and siblings would typically be considered non-arm's length to him. As well, the spouses of all the forgoing would be non-arm's length to Martin.

This wide inclusion is very important because the parties to a non-arm's-length agreement will be taxed based on fair market value regardless of the original transaction price in an agreement. While the income tax consequences will be adjusted for both parties to reflect the revised fair market value, a PAC can prevent adverse tax consequences that would otherwise arise from the application of anti-avoidance provisions. Examples of this include the shareholder benefit rules, the attribution provisions, and the benefit rules that apply to tax-free rollovers or a share-for-share exchange.

A price adjustment clause is not a simple safety net inserted into non-arm's-length transaction agreements in order to minimize negative consequences. To have the intended mitigating effect, the PAC must be considered a valid clause, which means it must meet specific conditions, including the following:

- There must be a bona fide intention to transfer at fair market value.
- Fair market value must be determined in good faith, and using a fair and reasonable method. The CRA suggests that a significant difference between the original fair market value of the transaction and the adjusted "real" fair market value may indicate that the parties did not undertake a genuine effort.
- The valuation method must be properly applied with regard to the specific circumstances. For example, it may not be reasonable to use a liquidation method to establish the value of a financially viable and profitable going concern.
- Valuation experts are not required; however, they can be helpful to ensure the valuation methodology chosen is reasonable and considers all relevant circumstances.
- The shortfall or excess on the adjusted price must be refunded or paid between the parties, or adjusted as a legal liability.

Failure to meet the CRA's requirements would mean that the price adjustment clause is disregarded and the parties would be subject to the resulting negative consequences arising from the application of any relevant anti-avoidance provisions.

Consider the following scenarios.

Scenario 1:

In 2012, Carlie exchanged her common shares of Opco, taking back consideration comprised of redeemable, retractable, fixed-value preferred shares valued at $10 per share. The $10 redemption value of the preferred shares was set at the fair market value of the Opco common shares at the time of the exchange. There was a price adjustment clause completed in case the fair market value of the Opco common shares was changed because of an audit arising by the CRA.

The price adjustment clause provided that if the preferred shares were redeemed before any adjustment to the fair market value, the corporation would be liable for paying any additional proceeds to Carlie. Opco redeemed 10 shares each month in 2013 and 2014. In January 2015, the CRA issued their opinion that the original value of the shares was actually $15 per share. The firm accepted the CRA's assessment and, in February 2015, the firm paid Carlie an additional $5 per share for the 240 shares that had been redeemed.

OUTCOME:

It is the CRA's view that the additional payment of $5 per share to Carlie in 2015 relates to the redemption of the Opco shares, and would be treated as a dividend.

The additional payment arises from a right relating to the share and would be subject to taxation in the year of receipt (2015). The payment would not be treated as a retroactive redemption, but rather a current payment of a dividend at the time of receipt based on the interpretation of the provision for the redemption of shares.

Scenario 2:

Mom sells the common shares of her operating company (Opco) to her daughter for $3,000,000, even though they have a sense that the fair market value is probably closer to $5,000,000. Mom and daughter derived the $3,000,000 value based on an amount they felt mom needed for retirement.

Based on the original sale price, mom reports a $3,000,000 capital gain assuming a nominal adjusted cost base. Daughter's adjusted cost base is $3,000,000, which represents the amount she paid to mom for the shares. Mom and daughter put a price adjustment clause in their transfer agreement.

A subsequent re-assessment by the CRA, and validated by the Tax Court, determined the fair market value was $5,000,000, not $3,000,000, at the time of the original transaction. They also found that the price adjustment clause was not valid based on a review of the circumstances surrounding the valuation.

OUTCOME:

While a price adjustment clause was in place, the finding that it was not valid results in the application of anti-avoidance rules. The income tax outcome of an invalid price adjustment clause is the same as not having one in place. Mom will be reassessed and taxed on deemed proceeds of $5,000,000, the revised fair market value of her shares. However, the daughter's adjusted cost base is not eligible for a similar adjustment; instead, her adjusted cost base remains at $3,000,000. Eventually, when daughter sells the Opco shares, her overall capital gain will include the $2,000,000 capital gain already reported by her mother.

If the price adjustment clause had been valid, daughter would have been required to pay mom an additional $2,000,000 to reflect the revised fair market value, and mom would have paid tax on the additional $2,000,000 (now $5,000,000 rather than original $3,000,000). The daughter's adjusted cost base would have increased to $5,000,000.

Price adjustment clauses can be an extremely valuable tool in agreements between non-arm's length parties. However, they will only be successful in situations where it is clear that the parties had a legitimate intention to transact at fair market value.

I/R 7900.00, 8301.00

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