INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

11 King Street West, Suite 1600, Toronto ON M5H 4C7
T 416.364.2754 | F 416.364.4861

www.iiac.ca

Barbara J. Amsden
Managing Director
416.687.5488/bamsden@iiac.ca

February 27, 2015

Ms. Mary Pat Baldwin, CA
Manager, Deferred Income Plans Section
Income Tax Rulings Directorate
Canada Revenue Agency (CRA)
320 Queen Street, 16th floor, Place de Ville, Tower A
Ottawa, ON K1A 0L5
Contact: mary-pat.baldwin@cra-arc.gc.ca/613-957-2087

Dear Mary Pat:

Re: TFSAs – Further Information on Unintentional Overdrafts

Thank you very much for your participation in our joint call on February 24, 2015 to discuss issues surrounding carrying on a business and unintentional overdrafts in tax-free savings accounts (TFSAs) as addressed in a number of letters sent to the CRA and Department of Finance on the subjects. I am taking the liberty of also copying Priceela Pursun, Special Advisor, Pensions, of Finance's Tax Policy Branch and Dave Wurtele of your team on this letter, as both have asked for information about the cases of unintentional overdrafts that we had raised.

We appreciate your comments regarding the CRA's recent audit activity. We share your concerns about the integrity of the tax system and the need to scrutinize aggressive tax avoidance schemes. Taxpayers that open and invest through a TFSA should not be able to gain unintended and inappropriate tax advantages. Our concern, however, is that the tools available to the CRA in challenging certain taxpayers highlight certain technical issues that could be applied against all TFSAs; our concern is that these issues create technical risk to the financial services industry, which acts in various roles as trustees and brokers for TFSAs. These risks, if not addressed, create pricing concerns for those institutions that could result in less robust access to these products. TFSAs are essentially commodity products offered to ordinary Canadians. The rules and their application need to be very clear and very predictable in order to be offered efficiently. Tests that involve judgement that need to be applied, or that rely upon discerning an abusive or anti-avoidance motive, lack predictability (even if they are applied only to a small subset of investors).

Regarding the possibility of borrowing within a TFSA, our products are specifically designed to prohibit a debtor-creditor relationship or a "lending" in the ordinary commercial sense. The rules are quite clear regarding the intention of the legislation: taxpayers are not to gain an advantage through "leverage" by having access to borrowing. Our concerns relate solely to unintended and incidental short-term overdrafts that arise primarily due to frictional delays in the settlement of purchases and sales of securities within TFSAs. These overdrafts are not meant to enhance TSFA values through the use of leverage. They arise through the ordinary functioning of the capital markets and are not intended to provide access to credit where the investor could have exposure to investments that are greater than the unlevered assets in the plan. The Department of Finance has suggested we work with you to find appropriate administrative relief. We appreciate your efforts in that regard.

We also thank you for your update on the development of the three Folios and of material by the Registered Plans Directorate. These materials sound like they will be very helpful in increasing predictability in the administration of deferred products. We would very much appreciate the opportunity for a restricted group of association staff and selected member experts, on a completely confidential basis, to review the Folios when you think appropriate, not with a view to raising policy or new technical issues, but rather to help ensure that the Folios when issued are able to be address the practical situations encountered by our members. We also would appreciate the appropriate contact in the Registered Plans Directorate as we would like to follow up in that area as well.

Attached is the additional information requested regarding accidental overdrafts that sets out the practical technical issues encountered by our members. We hope these will assist you in the formulation of your administrative policy and would be pleased to discuss any of these instances with Dave or you, or others among your staff.

If it would be helpful – and we have done this for CRA financial institution audit teams – we would also be pleased to meet with you in Ottawa or via videoconference from time to time regarding the operation and administration of deferred products to assist you in Rulings and any other interested CRA directorates when considering rulings requests or administrative options.

Please let us know if there is anything else that we can do to assist you in your review.

Yours truly,

Cc: Ms. Priceela Pursun
Mr. Dave Wurtele

‘BORROWINGS’ AND ‘INADVERTENT OVERDRAFTS’

Below is a summary of what we understand the issues to be regarding borrowing and inadvertent overdrafts in TFSAs with an elaboration of inadvertent overdraft examples.

1. ‘Borrowings’ of Concern to the Government

We understand that a policy concern regarding TFSAs is that taxpayers not be allowed to use leverage within a TFSA to increase the amount of assets that may generate income that is permanently tax-sheltered. For our purposes, we will refer to this as a “true” borrowing that creates leverage, in contrast to a “procedural” or an “administrative” overdraft resulting from processing of the types referred to in our July 3, 2014 letter.

A true borrowing is a matter of considerable importance within the securities industry, and as such is subject to extensive oversight and supervision, as well as to regulatory examination. Investment Industry Regulatory Organization of Canada (IIROC) Notice 14-0044 (February 19, 2014) Borrowing for Investment Purposes – Suitability and Supervision, provides guidance published by IIROC, an entity that regulates all securities dealers and IIROC advisors. The guidance links to an investor information bulletin that states:

> “Borrowing-to-invest strategies might include borrowing to top up your RRSP, borrowing against the equity in your home, and borrowing “on margin” in your brokerage account – an arrangement in which the firm lends the investor cash to buy stocks with the account serving as collateral for the loan.”

A true borrowing from banks and other deposit-taking or lending companies for RRSPs or TFSAs requires a loan agreement, and there would not be provision for this type of borrowing in an IIROC dealer. Borrowing on margin depends on an agreement with the dealer. Referred to as a margin agreement, it must be signed by the client before the client undertakes trades on credit. Not only do both forms of borrowing require a formal agreement, but the client effectively makes a conscious decision as to when and how much to “borrow”.

2. ‘Administrative/Procedural Overdrafts’ of No Concern

The ‘administrative/procedural overdrafts’ we raised are accidental, and not done to create leverage for inappropriate gains. In fact, it is quite unlikely that a client would know about these situations before the dealer did. While there is a very remote chance a client could act deliberately to go into an administrative overdraft situation, should this be repeated, the dealer would raise concerns and address the situation. Below we have re-ordered the administrative/procedural overdraft examples, with some additional information, into ones that are essentially always of very short duration and quickly or naturally reversed, and others that require more proactive intervention, but that we believe also should be resolved administratively.

In both cases, it is important to understand that financial institution processes are set up to facilitate transactions because: (i) the overwhelming majority of millions of transactions go through without incident and (ii) to block transactions, before processing, risks further downstream effects on the marketplace. In fact, in the industry the inadvertent overdrafts are not considered to be a borrowing or a loan product, but are referred to as a trading accommodation.

a. Transactions of very short duration that are quickly or naturally reversed or not client-directed

i. Settlement mismatch

Some securities settle (exchange of cash for the security in a secure environment called The Canadian Depository for Securities or CDS) on the same day as the related transaction (known as Trade Date plus 0 or T+0) or one, two or three days following (respectively T+1, T+2, or T+3) depending on industry-wide standards based on the complexity of the underlying instrument and sometimes other matters. Over time, this period has shortened, for example, from T+5 to T+3 in the 1990s. The Bank of Canada and Ontario Securities Commission have oversight over CDS. The standard settlement cycles are as follows:

Security	Settlement Date
Canadian and U.S. equities; long-term bonds (over 3 years); mortgage-backed securities; mutual funds (except money market funds); strip coupons (over 1.5 years); eurobonds; foreign equities (usually)	T+3
Short-term bonds (3 years or less); strip coupons (under 1.5 years); gold and silver certificates	T+2
Canadian and U.S. options; U.S. treasury bonds; money market funds	T+1
T-bills; GICs; other money market instruments	T+0

Note: The industry is again in the process of investigating a shorter maximum cycle of T+2.

Given different settlement dates for different types of investments, on occasion, there can be a mismatch, meaning an overdraft for a day or so. For example, if a short-term bond were sold and a T-bill money market instrument were bought on the same day, there would be a two-settlement-day mismatch where the T-bill had to be paid for before cash was received for the bond. In this instance, the decision or intention of the investor is not to hold two assets at once or to borrow, however, financial institutions’ systems may automatically charge a small amount of interest (two-days’ interest), which will show up on the client’s statements. The overdraft would correct naturally when the later-settling security transaction settles.

Settlement mismatches can also occur when foreign exchange rates change during the period between purchase/sale and settlement.

On rare occasions, accounts may go into an overdraft position to pay for administrative fees assessed before a trade settles to cover fees.

Also, while an investor cannot buy without selling (or injecting cash), and while a sale order is always placed before a purchase, on rare occasions – even with matching settlement dates – the purchase may get processed first.

ii. Trading error

A financial institution may inadvertently purchase a larger quantity of an investment than instructed by the client or execute a sale of fewer holdings than the client requested. When a trading error is made by a financial institution, there is no way for a system to recognize it before automatically charging interest. It is possible for this to take longer to be identified, however, there is no client intent to borrow in this case and interest typically would be reversed.

iii. Portfolio rebalancing

Typically, clients'/taxpayers' investment plans are designed for longer-term goals with a mix of various types of investments. Portfolio rebalancing is a typical strategy used, for example, as a client/taxpayer ages, to reduce risk or volatility in their account(s) by moving from more higher-risk equity holdings to lower-risk fixed-income securities that produce more revenue (dividends, interest) than capital gains. For example, holdings could go from 70% equity/30% fixed income, to 60/40, 50/50, 40/60, etc. over time. Some firms have automated offerings, where a client is using a particular asset allocation strategy, based on percentages, and occasionally a brief overdraft arises where rounding occurs amongst the different categories. Again, records will show an overdraft but there is no client intent to borrow in this case, and interest typically would be reversed.

b. Infrequent unintended overdrafts, usually quickly fixed

i. NSF cheque, debit or withdrawal

A TFSA holder may inadvertently write a cheque or authorize an inter-account or inter-financial institution debit that is, respectively, returned marked 'not sufficient funds' (NSF) for a TFSA contribution and purchase, or is charged back as an NSF debit. In extremely rare situations, for example, where there is a joint account, a withdrawal may be processed before the settlement of a sale.

If a cheque were returned NSF, there were an NSF debit chargeback or there were an unforeseen withdrawal, the account would go into an overdraft position until the NSF amount was rectified. It is extremely unlikely that a transaction would be reversed in this scenario. Rather, the dealer would contact the client quickly for prompt delivery of alternate funds or instructions, and any repeated behaviour would be dealt with strictly.

ii. Fees

On occasion, there may be no liquid amount in a TFSA account to cover fees; the client will be contacted to rectify the overdraft immediately.

iii. Stock certificate

Extremely rare in today's electronic and predominantly nominee financial marketplace, a TFSA holder may deposit a physical stock certificate, which is only found to be invalid after it is sold. The value of the "bad" security would be charged back to the dealer and from there to the TFSA, which could go into an overdraft position if there were not other free funds available. The dealer would contact the client to bring in funds or otherwise ensure that the account was returned into the black quickly.

In the above cases, clients often will have no margin agreement with their dealer that would permit borrowing or leverage, even if the problem were to arise in their non-registered account(s), further supporting our view that these instances are "trading accommodations" rather than any intent to borrow. We hope that the foregoing information is helpful in confirming our expectations regarding borrowing and providing greater clarity regarding the explanation of accidental overdrafts.