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Ellen Roseman

Many Canadians who opened a tax-free savings account are getting a nasty surprise this month.

They're being penalized for excess contributions, even though they kept their balances under the $5,000 annual limit.

If you have contributed the maximum to a TFSA and you withdraw any of your money, you must wait until the following year to contribute again.

Removing and replacing money in a single year means you'll get dinged for 1 per cent of the amount you contributed over the initial $5,000.

Take Catherine Lyall, who put $5,000 into a TFSA last year. Short of money to pay bills, she took out $4,970 from the account and put it back later in 2009.

The CRA said she had over-contributed $4,970 for six months – or $29,820 in total – and had to pay back 1 per cent (or $298.20).

Meanwhile, she earned about $48 of tax-free interest – far outweighed by the penalty.

Qasim Abbas has a similar story. After putting $5,000 into a TSFA on Jan. 2, 2009, he took out $1,500 on Jan. 26 and replaced it on Feb. 2, 2009.

He was told he had made a $1,500 over-contribution for 11 months – or $16,500 in total – and he owed $165.

Transfers can also get you into trouble. Witold Borozynski opened a tax-free account with ING Direct on Jan. 1, 2009. Finding a better offer at HSBC, he transferred $4,999 from ING to a TFSA at HSBC on Jan. 22, 2009.

He was over the limit in the first month of the year, the CRA said. He owed 1 per cent of $4,999 times 12 months – or $59,988 in total – which meant a tax bill of $599.98.

"I feel I was charged taxes on money I never had," he said. "Maybe it's a classic example of missing the super-fine print."

Federal finance minister Jim Flaherty announced technical changes last October designed to restrict tax avoidance schemes and prohibit asset transfer transactions between TFSAs and other registered or non-registered accounts.

But he didn't say transfers of TFSAs from one institution to another would be penalized – or transfers within a single institution – even though it's happening to some taxpayers.

Max Peterson transferred his TFSA from a TD Waterhouse discount brokerage account to a TD Canada Trust branch last year. Now he's learned that the transfer was counted as a new contribution.

Gerry Vercaigne did the opposite, moving his TFSA from a TD Canada Trust branch to his TD Waterhouse brokerage accounts. He's been told to pay $392.62 in tax on $39,626 in over-contributions – and his wife, who did the same thing, has a similar tax bill.

I'm hearing from many people ordered to pay tax on so-called TFSA over-contributions. Their letters, dated June 1, demand a response by the end of the month.

Taxpayers have two options, explains CRA spokeswoman Caitlin Workman. They can send in payment right away if they agree with the proposed TFSA return for 2009. Or they can complete a form (RC243-SCH-A), showing the changes they want to make.

Disagreement can be costly if you have no case.

“If we do not receive your TFSA return and payment on or before June 30, 2010, we will issue an assessment, which will include any penalties and interest that may apply,” Brigitte Latimer, CRA assistant director of data assessment, wrote to Abbas.

Many people are going online with complaints at the Canadian Tax Resource Blog, http://blog.taxresource.ca, and my own blog, http://www.ellenroseman.com.

Taxpayers and financial institutions need help understanding how the TFSA rules work. It would be nice to see Ottawa do a public education campaign and waive penalties for over-contributions made in error during the first year.

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