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Tax Law

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Tax Planning And Interest Deductibility After *Lipson*

The Supreme Court of Canada does not hear a large number of tax cases so these decisions are usually significant. This can certainly be said for the decision in *Lipson* v. *The Queen* ("*Lipson*") released on January 8, 2009. *Lipson* is particularly important because it gave the highest court in Canada the opportunity to comment on:

1. The ability of taxpayers to arrange their finances in a manner that allows them to obtain a tax deduction for interest paid on amounts that have effectively been borrowed to purchase personal assets; and
2. The application of the General Anti-Avoidance Rule ("GAAR") in the *Income Tax Act* (Canada) (the "*Tax Act*") to tax planning that the Minister of National Revenue (the "Minister") may find offensive.

Although *Lipson* appears to support the proposition that taxpayers can, in most instances, structure their affairs to obtain an interest deduction, the decision has cast uncertainty as to when the GAAR will apply. *Lipson* therefore serves as a reminder that while it may be possible to structure borrowing arrangements to obtain interest deductions in all types of tax planning, the GAAR may impede taxpayers' ability to realize the tax benefits that some planning promises.

Interest Deductibility – The *Singleton* Decision in 2001

The leading case regarding interest deductibility planning is the Supreme Court of Canada's 2001 decision in *Singleton* v. *The Queen ("Singleton")*. Generally, interest paid on money borrowed to earn income from a business or property is deductible, whereas interest paid on money borrowed to fund personal purchases is not. In *Singleton*, Mr. Singleton, a partner in a law firm, withdrew capital from the partnership and used the money to purchase a home. Immediately after purchasing the house, he borrowed the same amount of money he withdrew from the partnership and contributed the borrowed money to his partnership capital account. For tax purposes, he deducted the interest on the borrowed money on the basis that the money was used to earn income from the partnership. The Supreme Court accepted his position that the interest was deductible because the direct use of the borrowed money was to contribute capital to the partnership, even though the transactions were implemented to purchase the residence. This means taxpayers can structure their finances to obtain an interest deduction when purchasing personal assets provided that the direct purpose of the borrowed money is to earn income from a business or property. The application of the GAAR was not in issue because the facts in *Singleton* occurred before the GAAR was law.

The General Anti-Avoidance Rule

The purpose of the GAAR is to deny tax benefits achieved by a taxpayer when a plan is implemented that complies with the literal interpretation of the *Tax Act,* but amounts to an abuse of its provisions. Since the *Tax Act* cannot conceive of every tax planning situation, the GAAR was introduced to apply in some cases when tax plans are implemented that exploit certain loop-holes in the *Tax Act.* The GAAR is not meant to apply to all tax planning. For the GAAR to apply, three conditions must be satisfied:

1. There must be a tax benefit obtained from one of the transactions implemented;
2. The transaction must be an avoidance transaction, meaning that the only purpose of the transaction is to obtain the tax benefit and that there is no other non-tax purpose for the transaction; and
3. The transaction or series of transactions implemented must be abusive, meaning that the avoidance transaction is inconsistent with the object, spirit or provisions of the *Tax Act* which the taxpayer relies on.

The Canada Revenue Agency ("CRA") usually only applies the GAAR when the first two conditions are clearly met. If the taxpayer disputes that there is a tax benefit or an avoidance transaction, the taxpayer must prove that they do not exist. Most GAAR disputes arise because the taxpayer

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and the CRA disagree upon whether the avoidance transaction or transactions is abusive. When this occurs, the Minister must prove that the use of the avoidance transaction or transactions is inconsistent with the object, spirit or provisions of the *Tax Act*.

Lipson provided the Supreme Court with the opportunity to clarify when or if interest deductibility planning like the type implemented in *Singleton* is acceptable under the GAAR and how the GAAR should apply to tax planning.

Facts in Lipson

The facts in *Lipson* are similar to those in *Singleton.* In *Lipson*, Mr. Lipson wanted to purchase a house using borrowed money, but wanted to structure the transaction so that the interest was deductible. If he withdrew money from the family corporation he owned, he would be taxed on the distribution. Accordingly, he entered into a series of transactions with his wife.

One day prior to the closing of the house purchase, Mrs. Lipson borrowed $562,500 from the bank (the "Loan") on the condition that she would repay the Loan the next day. Mrs. Lipson used the borrowed money to purchase shares of the family corporation from Mr. Lipson. The *Tax Act* allows a spouse to transfer assets with accrued capital gains to the other spouse without triggering the accrued tax liabilities on the assets. This tax-free transfer will not occur if fair market consideration for the assets is paid by the purchasing spouse and the spouses file a joint election for the transfer to occur at value. Although it appears Mrs. Lipson paid fair market consideration for the shares, the Lipsons did not file this election. As a result, Mr. Lipson did not realize a capital gain on the sale of the shares to his wife. As a consequence, and this is important in this case, when a transfer of assets between spouses occurs on this tax-free basis, another rule in the *Tax Act* (the "Spousal Attribution Rule") provides that any income or loss realized on the transferred assets will be attributed to the spouse that transferred the assets. Since Mr. Lipson transferred the shares to Mrs. Lipson on a tax-free basis, any income or loss realized on the shares would be attributed to Mr. Lipson under the Spousal Attribution Rule.

The day after Mr. Lipson transferred the shares to Mrs. Lipson, Mr. Lipson used the $562,500 received from Mrs. Lipson to purchase the house. That same day, the Lipsons obtained a mortgage on the house for $562,500 (the "Mortgage") and Mrs. Lipson used the Mortgage proceeds to repay the Loan. Over the next three years, Mrs. Lipson incurred interest of almost $105,000 on the Mortgage and received dividends of approximately $54,500 on the shares. The Lipsons took the position that the Spousal Attribution Rule applied to the dividend income and the mortgage interest. Accordingly, Mr. Lipson included in income the dividends received on the shares and deducted the mortgage interest because the Mortgage replaced the Loan, and the Loan was used to acquire the shares.

The Minister applied the GAAR to prohibit the interest deduction on the basis that the transactions were abusive because the purpose of the transactions was to borrow money to purchase a home and not the shares. The Tax Court of Canada and the Federal Court of Appeal agreed with the Minister.

Supreme Court of Canada's Decision

The Supreme Court's decision was not unanimous. Four of the seven judges (the "Majority") denied Mr. Lipson's deduction of the interest expense. The three dissenting judges would have allowed the interest deduction. Although the decision to deny Mr. Lipson's interest deduction itself may not have been surprising, the Majority decision provided reassuring comments on interest deductibility planning but cast uncertainty on the potential application of the GAAR to tax planning.

The Supreme Court of Canada's Comments on Interest Deductibility

The Majority and dissenting judges agreed that the interest on the Mortgage was deductible even though it was effectively used to acquire a personal asset, but could not agree that Mr. Lipson could claim the interest deduction. This is important because the Minister had argued that the GAAR essentially reversed the result in *Singleton* by denying any interest deduction where a taxpayer structures his or her affairs to use borrowed money to directly purchase an income producing asset when the economic

realty is that the borrowed money is used to enable the taxpayer to buy a personal asset. In *Lipson*, the Supreme Court concluded that there was no misuse of the interest deductibility provisions of the *Tax Act*.

However, the Majority concluded that allowing Mr. Lipson to claim the interest deduction was a misuse of the Spousal Attribution Rule. The Majority decision permitted Mrs. Lipson to deduct the interest but it is unclear whether she had sufficient income in those years to use the interest deduction. The dissenting judges agreed that the interest was deductible but they thought that Mr. Lipson was entitled to the deduction.

The Supreme Court of Canada's Comments on the GAAR

The Majority and the dissenting judges disagreed as to whether the application of the Spousal Attribution Rule to provide Mr. Lipson with the interest deduction was abusive under the GAAR. In fact, two separate sets of dissenting reasons were issued. Since three different judges wrote opinions on the application of GAAR and only seven of nine judges heard the case, the value of the GAAR analysis as it might apply to future tax planning cases is uncertain. Consequently, this case did not resolve the uncertainty surrounding the application of the GAAR, and in fact may have added to the uncertainty.

The Majority concluded that to use the Spousal Attribution Rule and give Mr. Lipson the interest deduction was abusive under the GAAR because the Spousal Attribution Rule was designed to prevent spouses from reducing taxes by transferring income producing assets from a higher-income earning spouse to a lower-income earning spouse. The Majority recognized that applying the GAAR to deny the operation of the Spousal Attribution Rule could create uncertainty, but were of the view that the GAAR is intended to apply to a transaction that would otherwise be valid to prevent abusive transactions and maintain fairness in the tax system even if this will create some uncertainty.

Justice Binnie, in one of the dissenting judgments, found that the Spousal Attribution transaction was not abusive because the Spousal Attribution Rule operated as it was intended. In his view, Parliament intended that the Spousal Attribution Rule would operate even if this meant tax would be reduced. The purpose of the Spousal Attribution Rule is not to prevent income splitting but to permit the transfer of property between spouses and prescribe the attribution of income and expenses to the transferring spouse. In his opinion, to apply the GAAR when a provision operates as intended would create uncertainty in the tax system as to whether the GAAR would apply.

Justice Rothstein, writing the second dissenting opinion, concluded that the GAAR did not apply because the *Tax Act* contained a specific provision that dealt with tax avoidance when the Spousal Attribution Rule is used. If this specific provision applied, the Spousal Attribution Rule would not have attributed the dividend income on the shares and the interest expense to Mr. Lipson. Justice Rothstein was of the view that when a specific anti-avoidance rule exists to deal with the tax planning that was implemented, as there was in this case, the GAAR cannot apply. Since the Minister did not argue the application of this specific anti-avoidance rule, Justice Rothstein concluded the Mr. Lipson should not be denied the interest deduction. Had the Minister argued that this specific anti-avoidance rule applied, Justice Rothstein would have not allowed the Spousal Attribution rule to apply, and Mr. Lipson would not have been attributed both the dividend income and the interest expense.

The Future of Interest Deductibility Tax Planning and Tax Planning in General

So where does *Lipson* leave us, and what, if any, practical lessons can we take from the decision?

From an interest deductibility standpoint, tax planning similar in nature to the type in *Singleton* where a taxpayer organizes his or her affairs to obtain an interest deduction by using debt to finance investments or businesses and equity to purchase personal assets should be acceptable. If you own a business or have significant investments and need to borrow to purchase personal assets, it may be possible to structure your financing so that you can deduct the interest on the borrowed money. That being said, as with all tax

planning, there is a risk that the GAAR may apply to deny an interest deduction, but this risk, after *Lipson,* appears minimal unless the steps implemented to obtain the interest deduction require the use of other tax provisions in a manner that a court would consider was not intended.

The risk that the GAAR applies to tax planning in general has become less certain after *Lipson* but that does not mean that *Lipson* should be ignored or that all tax planning is subject to the GAAR. Some commentators have argued that *Lipson* imposes a "smell-test" in that if a transaction is implemented for a tax reason only, and the tax benefit obtained does not look or smell right, then the GAAR should apply. Other commentators argue that *Lipson* is not that far-reaching but the risk of the GAAR applying increases when the taxpayer must implement a transaction for the sole purpose of obtaining the tax benefit of a specific tax provision, and that doing so is inconsistent with the purpose of the specific tax provision or the general scheme of the *Tax Act.* A third set of commentators think that since the Supreme Court issued three decisions, and that only seven judges heard the case, *Lipson* may not provide any guidance as to when the GAAR should be applied, and we may have to wait until another case involving the GAAR reaches the Supreme Court. Regardless of which position is correct, if you are undertaking tax planning, the possible application of the GAAR must still be considered.

Lipson should not be interpreted to mean tax planning is dead. In fact, most tax planning remains valid and will not be subject to a challenge under the GAAR. The difficulty lies in distinguishing between valid and abusive tax planning when aggressive tax planning strategies have been implemented. From a practical standpoint we need to understand when the CRA will apply the GAAR after *Lipson*. Although the CRA's comments after *Lipson* have been limited and despite claiming that it will not be applying a "smell test" to tax planning, the CRA appears ready to challenge some of the more aggressive tax planning products that produce tax results that appear too good to be true. The CRA may not be successful given the uncertainty left by *Lipson*, but if you are assessed by the CRA, you should be prepared for litigation so that you do not lose the tax benefit. This is usually a fight most taxpayers would rather avoid but *Lipson* may provide the Minister with the courage to litigate where the CRA determines that abusive tax planning has occurred.

Bryan McNulty heads up Pallett Valo's new Tax Practice.

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