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MARCH 2009

Interest Deductibility and the GAAR
Lipson v CRA

HIGHLIGHTS

- On Thursday, Jan. 8, 2009, the Supreme Court of Canada released its decision in the Lipson case and by a split decision (four to three) dismissed the taxpayer's appeal.
- The General Anti-Avoidance Rule (GAAR) was found by the majority to apply.
- As a result the court found the mortgage interest deduction that had been claimed by Mr. Lipson was not deductible from his income.
- Abusive tax avoidance was established under the Income Tax Act (Canada) (ITA) s. 245(4), because the majority of judges found that one of a series of transactions entered into by Mr. and Mrs. Lipson constituted an abuse and misuse of s. 74.1(1) of the Act.

The Supreme Court confirmed that the series of transactions would not have otherwise been subject to the GAAR, except for the inclusion of a transaction involving the use of the s.74. 1(1) spousal attribution rule, in a manner the majority found abusive. Notably, all of the judges agreed there would have been no issue with the deductibility of the mortgage interest in the circumstances of this case had the s74,1(1) spousal attribution rules not been abused. All of the judges also clearly acknowledged the right of taxpayers to rearrange their affairs using debt or equity to achieve tax-deductible interest expense for their income- producing assets or property.

THE FACTS

The taxpayer, Earl Lipson, and his wife, Jordanna, jointly entered into an agreement to purchase a family home. The day prior to the closing of the house purchase, Jordanna borrowed $562,500 from a bank to finance the purchase of shares in Earl's family corporation. She paid the borrowed money directly to Earl, who transferred the shares to her. Earl and Jordanna then obtained a mortgage from the bank equal to $562,500. The same day as the closing of the house purchase, the mortgage loan funds were used to entirely repay Jordanna' s share purchase loan.

The Lipsons conceded the transactions were for the purpose of tax avoidance; however, they took the position that the avoidance was not abusive under the GAAR. Their position was, the mortgage proceeds were used to purchase the shares so the interest was deductible under s. 20(1)(c) due to s. 20(3) of the ITA. In addition, their position was because Earl did not make an election to the contrary, the attribution rules under s. 74.1(1) applied so the shares were deemed to be sold at Earl's adjusted cost base (ACB) and Earl did not have to report a capital gain on the sale of the shares. They argued that income or loss on the shares sold to Jordanna attributable back to Earl and the interest on the loan was deductible by Earl. On his 1994, 1995 and 1996 tax returns, relying on the s. 74.1(1) spousal attribution rules, Earl applied his wife's interest deduction on the mortgage loan to his own income to reduce his tax payable.

The Canada Revenue Agency (CRA) denied the deductibility of the mortgage interest by Mr. Lipson, arguing the purpose of the series of transactions was to convert non-deductible personal interest on a personal home mortgage into deductible interest solely for tax avoidance. and the interest on transactions was to convert non-deductible personal interest on a personal home mortgage into deductible interest solely for tax avoidance. CRA argued that the "object, spirit and purpose" of the s. 74.1(1) spousal attribution rule is an anti-avoidance provision aimed at preventing income splitting. Accordingly, CRA took the position that using this provision to avoid tax is contrary to the purpose of s. 74.1(1) and therefore an abuse and misuse of the provision and, as a result, the GAAR applied to deny the deduction. Both the Tax Court of Canada and Federal Court of Appeal dismissed the taxpayer's appeal.

APPROACH TO GAAR

The GAAR is applied to determine whether a transaction resulting in a tax benefit was an avoidance transaction that was directly or indirectly a misuse or abuse of the provisions of the ITA. The GAAR is a provision that can be applied generally, and is typically used to address transactions falling outside the scope of specific anti-avoidance provisions. In *Lipson,* a specific spousal attribution anti-avoidance rule was available but not at issue. The court determined the GAAR was applicable.

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EXPERIENCE. TRUSTED ADVISORS TO ACCOMPLISHED ENTREPRENEURS.™

Establishing application of the GAAR
Is there a tax benefit? –
No – GAAR does not apply

If Yes, is the transaction an avoidance transaction? –
No - GAAR does not apply

If Yes, is the avoidance transaction abusive? –
No – GAAR does not apply
Yes – GAAR does apply

The taxpayer bears the onus of proving the first two steps above are not met. On the third step, the burden shifts to the Minister of National Revenue to establish "on a balance of probabilities" that the avoidance transaction results in abuse and misuse of a provision in the ITA (within the meaning of s. 245(4)).

THE JUDGEMENT

The Supreme Court of Canada held it has long been a principle of tax law that taxpayers may order their affairs so as to minimize the amount of tax payable. However, this principle has never been absolute, and Parliament has enacted the general anti-avoidance rule (GAAR) to limit the scope of allowable avoidance transactions while maintaining certainty for taxpayers.

Both the majority and dissenting opinions in *Lipson* applied the GAAR analysis approach as outlined in *Canada Trustco*. The *Lipson* case turned on the determination of the "object, spirit and purpose" of s. 74.1(1), and whether the Minister had satisfied the level of proof required to establish an abuse and misuse of these provisions. The justices came to opposing conclusions on this point. The majority determined the spousal income attribution rules under s. 74.1(1) were intended to prevent spouses from reducing tax by taking advantage of their non-arms-length relationship when transferring property between themselves.

As a tax benefit was gained by Mr. Lipson by the application of s. 74.1(1), which the Minister had established was in contravention of the "object, spirit and purpose" of the provision, the majority opinion held the transaction qualified as abusive tax avoidance. The interest deduction in computing income or loss attributable to Mr. Lipson was disallowed and the deduction was attributed back to Mrs. Lipson The majority analysis held that when assessing and understanding the nature of the individual parts of a series of transactions to determine whether abusive tax avoidance has occurred, the entire series of transactions can be considered. Individual transactions must be viewed in the context of the series to determine if a transaction can indirectly result in an abuse or misuse having occurred.

Two justices dissented because, in their opinion, the use of s. 74.1(1) by the taxpayer was not outside of the object, spirit or purpose of the section. The dissenting opinion also reiterated the principle stated in the earlier *Canada Trustco* decision regarding the level of proof required from the Minister to establish an abuse, stating "[i]f the existence of abusive tax avoidance is unclear, the benefit of the doubt goes to the taxpayer." There is an onus on the Minister of National Revenue to identify, with some precision, the object, spirit or purpose of the provision under the ITA that is frustrated by the impugned transactions. In this case, the dissenting judges did not find this onus had been discharged.

The minority were concerned that allowing the application of the GAAR sought by the CRA would give it "a sweeping effect not contemplated." The majority recognized its application might be viewed by some as increasing the uncertainty about the potential reach of the rule. It responded by stating: "To the extent that it may not always be obvious whether the purpose of a provision is frustrated by an avoidance transaction, the GAAR may introduce a degree of uncertainty into tax planning, but such uncertainty is inherent in all situations in which the law must be applied to unique facts."

For individual circumstances, please consult with your tax professional.
This information is provided by London Life Insurance Company and is current as of January 2009.