

Tax Alert

Supreme Court of Canada renders decision in *Lipson et al v the Queen*

Although the Supreme Court of Canada dismissed the appeal, it was careful to make it clear that a taxpayer may arrange his or her affairs to finance personal assets out of equity and income-earning assets out of debt.

Summary

In a much-anticipated decision, the Supreme Court of Canada dismissed the taxpayers' appeal in the case of *Lipson et al v the Queen*, 2009 SCC 1. The case centred around a couple who, through a series of transactions, attempted to obtain a deduction for interest on their home mortgage.

The court ruled that the general anti-avoidance rule (GAAR) should apply, and that the taxpayers had abused the tax system. The seven-judge panel was split four to three. This indicates that the decision was controversial among the justices, and perhaps explains why it took over eight months for the court to release its judgment.

However, even though the majority of the justices applied the GAAR, they were careful to point to out that it was not the refinancing aspect of the transaction that was offensive, but rather the taxpayers' use of the income attribution rules to reduce tax. As a result, it may be said that this decision is a victory for taxpayers in general, if not for the particular taxpayers in this case.

Background

In the *Singleton* case, 2001 DTC 5533 (SCC), the taxpayer successfully restructured his financial affairs to obtain an interest deduction for borrowed funds that could be technically traced to an income-earning use but were borrowed as part of a series of transactions that had as its ultimate purpose the purchase of a personal residence. The Supreme Court of Canada held that, absent a sham or specific provision in the *Income Tax Act* (the Act) to the contrary, the economic realities of a transaction cannot be used to recharacterize a taxpayer's bona fide legal relationships.

Singleton, however, was a pre-GAAR case. The Supreme Court's decision in *Lipson* was widely anticipated because it addresses the issue of whether the GAAR applies to "Singleton-like" refinancing transactions.

The facts in *Lipson* are straightforward. Mrs. Lipson borrowed approximately \$560,000 and used the loan proceeds to purchase shares of the family investment company from her husband. The \$560,000 was used by the Lipsons to purchase a home on a joint ownership basis. Mr. and Mrs. Lipson then, as co-covenantors, borrowed \$560,000, secured by a mortgage on their home. The loan proceeds were used to repay Mrs. Lipson's original loan. Because the share sale was between spouses, unless Mr. Lipson elected otherwise, his proceeds of sale (and Mrs. Lipson's cost) would be deemed to be the original cost of the shares. Since Mr. Lipson did not elect otherwise, he reported no gain on the share sale.

In addition, because Mr. Lipson did not elect otherwise, the income attribution rules in subsections 74.1(1) and 74.2(1) applied, so that any gain or loss, and any income or loss realized by Mrs. Lipson in respect of the shares, would be attributed back to Mr. Lipson. Therefore, Mr. Lipson both reported the dividend income from the shares and deducted the interest expense, and any net loss was used to offset other income. Mr. Lipson took the position that the interest deduction was justified on the basis of subsection 20(3): interest on borrowed money used to repay a loan made for an eligible purpose. The minister disagreed and reassessed to deny the interest deduction, and the taxpayers appealed to the Tax Court.

The sole issue at trial was whether the transactions involved in the case, which were admitted to be avoidance transactions within the meaning of subsection 245(3) of the Act, resulted in abusive tax avoidance within s. 245(4). Chief Justice Bowman of the Tax Court of Canada (who also happened to be the Tax Court judge in *Singleton* and denied the taxpayer's appeal at first instance in that case) had held that each of ss. 20(1)(c), 20(3), 73(1), 74.1(1) had been frustrated or defeated by the overall purpose and result of the transactions, since none of the relevant provisions contemplated making interest on money used to buy a personal residence deductible. The appeals were thus dismissed.

In reaching his decision, Chief Justice Bowman cited the decision of the Supreme Court of Canada in the *Canada Trustco Mortgage Company* case, 2005 SCC 54, and its companion case, *Kaulius*, 2005 SCC 55, in support of applying the GAAR to Mr. Lipson. He pointed out that what the Supreme Court directed was a unified textual, contextual and purposive analysis, not only of the sections giving rise to the tax benefit, but also of section 245. He concluded that the series of transactions resulted in a misuse of paragraph 20(1)(c) and subsection 20(3), since those provisions did not contemplate making interest on money used to buy a personal residence deductible. He described the case as an "obvious example of abusive tax avoidance" and "the very sort of contrived transaction" at which the GAAR was aimed.

The taxpayers appealed the decision to the Federal Court of Appeal. They argued that Justice Bowman erred by improperly importing into the subsection 245(4) analysis the concepts of economic purpose and reality, and by conducting the abuse and misuse analysis in light of the Lipsons' overall purpose of borrowing money to buy the home rather than by reference to the transactions as they actually took place and the legal relationships that were actually created (the borrowing of money by Mrs. Lipson to buy an income-earning asset). The taxpayers felt that Bowman strayed from the "principled approach" set out in *Canada Trustco* and *Kaulius*, and disagreed that, taken on an individual transaction basis, the transactions constituted abusive tax avoidance.

The panel of three Federal Court of Appeal judges dismissed the taxpayers' appeal. Justice Noël stated that Justice Bowman was entitled, in undertaking his s. 245(4) analysis, to give substantial weight to what he found to be the ultimate purpose of the series of transactions. The Supreme Court made it clear in both *Canada Trustco* and *Kaulius* that where there is no error in the construction of the relevant provisions or in the analytical approach, the question whether the transactions give rise to abusive tax avoidance belongs to the Tax Court judge. The Federal Court of Appeal could see no basis for interfering with the Tax Court decision.

The Federal Court of Appeal decision cast doubt on the Canada Revenue Agency's current assessing practices as outlined in Interpretation Bulletin IT-533, paragraph 15, which specifically accepts the result in *Singleton* and states that "a taxpayer may restructure borrowings and the ownership of assets to meet the direct use test." For this reason, there was great interest in the Supreme Court's approach.

Summary of the majority decision

Justice LeBel, in writing for the majority (Justices LeBel, Fish, Abella and Charron), endorsed the approach to the GAAR previously taken by the Supreme Court in *Canada Trustco*. Since the taxpayers conceded that the transactions were "avoidance transactions" as defined in subsection 245(3), the only issue was whether the transactions resulted in abusive tax avoidance within the meaning of subsection 245(4). The court reiterated that

the burden is on the minister to prove, on the balance of probabilities, that the avoidance transaction results in misuse or abuse within the meaning of subsection 245(4).

The first analytical step, according to Justice LeBel, is to conduct a unified textual, contextual and purposive analysis of the provisions giving rise to the tax benefit in order to determine their essential object, spirit and purpose. This involves identifying which provision is associated with each tax benefit. Here, the tax benefit of interest deductibility is associated with paragraph 20(1)(c) and subsection 20(3), and the tax benefit arising out of the use of the attribution rules by the taxpayer to reduce his income is associated with subsections 73(1) and 74.1(1). According to the court, the purpose of paragraph 20(1)(c) is to "encourage the accumulation of capital which would produce taxable income." Subsection 20(3) was enacted for greater certainty to make it clear that interest that is deductible does not cease to be deductible because the original loan was refinanced. According to Justice LeBel (quoting from Vern Krishna's *The Fundamentals of Canadian Income Tax*), the purpose of subsection 73(1) is to facilitate interspousal transfers of property without triggering immediate tax consequences. This is an exception to the general rule that capital gains and losses are recognized when property is disposed of. The rationale for permitting a taxpayer to roll over assets is that it is undesirable to impose a tax on transactions that do not involve a fundamental economic change in ownership, even though there may be a change in form or legal structure. Finally, the purpose of

attribution rules in sections 74.1 to 74.5 is "to prevent spouses (and other related persons) from reducing tax by taking advantage of their non-arm's-length status when transferring property between themselves."

Following its decisions in *Canada Trustco* and *Kaulius*, the next step in the analysis was a determination of whether the avoidance transaction frustrates the object, spirit or purpose of the relevant provisions. Justice LeBel, rejecting the Lipsons' argument, found that the entire series of transactions could be considered in order to determine whether the individual transactions misused or abused one or more of the provisions of the Act. Each transaction must be viewed in the context of the series. And, contrary to the decision of Chief Justice Bowman, and found not to be incorrect by the Federal Court of Appeal, Justice LeBel found that it was the "overall result" of the transactions rather than their "overall purpose," which was the focus of the subsection 245(4) analysis. Justice Binnie, in his dissenting judgment, agreed with Justice LeBel on this point.

Based on the foregoing, Justice LeBel concluded that the minister had failed to establish that the purpose of paragraph 20(1)(c) and subsection 20(3) had been misused and abused. In his view, the series of transactions did not become problematic until the taxpayer and his wife made use of subsections 73(1) and 74.1(1). According to the majority, to allow subsection 74.1(1) to be used to reduce the taxpayer's income tax from what it would have been without the transfer to his wife would frustrate the purpose of the attribution rules.

Singleton was distinguished on the basis that neither the GAAR nor section 74.1 was at issue in that case.

Justice LeBel addressed the argument that because of the specific anti-avoidance rule in subsection 74.5(11) (which neither party considered to be applicable), the GAAR could not apply. He stated that “where the language of and principles flowing from the GAAR apply to a transaction, the court should not refuse to apply it on the ground that a more specific provision – one that both the minister and the taxpayers considered to be inapplicable throughout the proceedings – might also apply to the transaction” (paragraph 45).

This conclusion may be considered to result in an expansion of the scope of the GAAR, which, in the language of subsection 245(2), applies only if no other provision prevents the intended benefit from resulting from the transactions in question. Indeed, Justice Rothstein based his dissenting judgment on the applicability of the anti-avoidance provision subsection 74.5(11), and hence the inapplicability of the GAAR.

Subsection 245(5) gives the court authority to determine the tax consequences as is reasonable in the circumstances to deny the tax benefits resulting from the transactions. In this case, Justice LeBel disallowed the attribution of the interest deduction to Mr. Lipson, thus leaving the interest deduction in the hands of Mrs. Lipson (see paragraph 51). In so doing, Justice LeBel split the net loss, which s. 74.1(1) otherwise attributed back to Mr. Lipson into its revenue and expense components, and permitted only the attribution of the revenue component – the dividends on the transferred shares.

Two dissenting judgments were written, one by Justice Binnie (with which Justice Deschamps concurred) and one by Justice Rothstein. According to Justice Binnie, the minister had failed to satisfy the onus of proving misuse or abuse of the attribution rules. According to him, “[i]t cannot be right that whenever a lower-income spouse borrows money to purchase shares from a higher-income spouse, there is an abuse of the spousal attribution rules unless the transferring spouse opts out of ss. 73(1) and 74.1(1), and thereby forfeits a tax benefit clearly available under the Act.”

Justice Rothstein took a completely different approach from both the majority and Justice Binnie. As noted above, he dismissed the

appeals on the basis that there was a specific anti-avoidance rule that the minister could have applied – subsection 74.5(11) – and the minister’s failure to invoke that provision was “fatal” to the GAAR reassessment.

Although the case was a four-three split decision, Justice Rothstein’s dissent suggests that the outcome was really five to two. Had the minister assessed under subsection 74.5(11) and GAAR in the alternative, it would appear that five of the justices would have upheld the assessment. The only distinction between the majority and Justice Rothstein in this respect is in whose hands the dividend income should have been assessed: Mr. Lipson (according to the majority applying GAAR) or Mrs. Lipson (according to Justice Rothstein applying subsection 74.5(11)). However, neither would have denied the interest expense to Mrs. Lipson.

Implications of the decision

In the end, this case may be considered a victory for taxpayers in general, if not for Mr. Lipson, because it makes it clear that debt structuring and restructuring is acceptable under GAAR even if the “ultimate purpose” is to match debt with eligible uses and equity with ineligible uses – even if the debt and ineligible uses are the “new” economic elements in the taxpayer’s overall position, and even if this is accomplished through non-arm’s-length transactions.

This decision may also have implications for other provisions of the Act, such as section 18.2, the controversial provision intended to restrict “double-dip” financing structures. Commencing in 2012, new section 18.2 of the Act will limit interest deductibility when a Canadian corporation has borrowed money that is used directly or indirectly for the purpose of funding an “inter-affiliate loan.” Given the Supreme Court’s statements in *Lipson* with respect to the ability of taxpayers to match debt with eligible uses and equity with ineligible uses, it may be possible to avoid the application of section 18.2 with appropriate planning, such as cash-damming.

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