Tax Memo

New Supreme Court Ruling on GAAR —Reflections on the Lipson Case

The Supreme Court of Canada started the new year by releasing its long-awaited decision in **Jordan B. Lipson, Earl Lipson v. The Queen**[1] on Thursday, January 8, 2009. A majority of the Court (four of the seven judges who heard the appeal)[2] held that the general anti-avoidance rule (GAAR) in section 245 of the *Income Tax Act* (the Act) applied to deny an interest deduction on a loan that was used, indirectly, to fund the purchase of a home, essentially upholding the result in the two courts below. Two separate dissenting judgments were delivered.

The majority's decision that GAAR applied to planning aimed at obtaining an interest deduction in these circumstances is not entirely surprising, given the make-up of the bench that heard the case. Nor is it particularly surprising that there were strong dissenting opinions. The consequence is that the majority's ruling on the applicability of GAAR is quite narrowly focused on the particular facts in issue and on the taxpayers' reliance on the "attribution rules" in the Act. In our view, the decision does not significantly change the basic framework for the analysis of when GAAR applies, as established by the Court in its 2005 decisions in **Canada Trustco**[3] and **Kaulius**.[4] Nor should this decision be taken to have established broader principles that would have major implications for tax planning that does not involve the use of the attribution rules.

Facts

Mr. Lipson and his spouse had agreed to purchase a house from an arm's-length vendor. The day before the purchase closed, Mrs. Lipson borrowed approximately $560,000 from a bank (the first loan) and used these funds to purchase shares of a private family investment corporation (LipsonCo) from her husband. Mr. Lipson used the $560,000 proceeds to complete the purchase of the home. Title was taken in their joint names.

The day after the closing, another loan (the second loan) for $560,000 was obtained from the same bank, secured by a mortgage on the house. The proceeds of the second loan were used to repay the first loan.

LipsonCo paid dividends to Mrs. Lipson for each of the three years that were reassessed. In two of those years, the interest expense on the second loan exceeded the dividends received by Mrs. Lipson, resulting in a loss. In one year, the dividends exceeded the interest expense, resulting in net income.

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1. **Lipson v. The Queen**, 2009 SCC 1. **Jordan B. Lipson** and **Earl Lipson** were two appeals with essentially the same issues and facts. Jordan B. Lipson agreed to abide by the result of the Court's decision in **Earl Lipson**.
2. The Court consists of nine judges. Due to an impending retirement, Chief Justice McLachlan did not sit on the bench that heard the case.
3. **The Queen v. Canada Trustco Mortgage Co.**, 2005 SCC 54.
4. **Kaulius v. The Queen (sub nom Mathew v. Canada)**, 2005 SCC 55.

PRICEWATERHOUSECOOPERS

The Canada Revenue Agency (CRA) did not challenge the $560,000 selling price of Mr. Lipson's shares of LipsonCo as not reflecting fair market value. Although the adjusted cost base of his shares is not revealed in any of the decisions, one can infer that there was an accrued capital gain.

Legislation

Several provisions of the Act were particularly relevant to the Lipsons' planning:

- Paragraph 20(1)(c) provides that a taxpayer may deduct interest expense on money borrowed to acquire an income-producing asset.
- Subsection 20(3) provides that when a taxpayer uses borrowed money to repay money previously borrowed, the borrowed money is deemed to have been used for the purpose for which the money previously borrowed was used.
- Subsection 74.1(1) attributes income or losses on transferred property from a transferee spouse to a transferor spouse.
- Subsection 73(1) provides for an automatic rollover when one spouse transfers property to another spouse, unless the transferor spouse elects out of the rollover pursuant to paragraph 74.5(1)(c). If the transferor spouse chooses to make this election:
  - any accrued capital gain in the transferred property is triggered on the transfer (i.e., the spousal rollover does not apply); but
  - attribution of income, losses, capital gains or capital losses from the transferee spouse to the transferor spouse is prevented.

  The subsection 73(1) spousal rollover applies even when the transferor spouse receives cash consideration on the transfer – a unique feature of the spousal rollover.

Mr. Lipson's Position

Mr. and Mrs. Lipson filed their tax returns on the basis that:

- the second loan was deemed by subsection 20(3) to have been used for the same purpose as the first loan, i.e., to purchase an income-earning property (the LipsonCo shares) and accordingly, the interest expense on the second loan was deductible by Mrs. Lipson pursuant to subparagraph 20(1)(c); and
- because Mr. Lipson had not elected out of the rollover, Mrs. Lipson's losses from the transferred shares (for the two years in which her interest expense exceeded the dividends received) and her net income from the shares (for the one year in which the dividends received exceeded her interest expense) were attributed to Mr. Lipson under the attribution rules.

The CRA's Position

The CRA reassessed on the grounds that GAAR applied to deny the interest deduction to Mrs. Lipson. The result was that Mrs. Lipson's gross income (i.e., the dividends) was attributed to Mr. Lipson, rather than her net income or loss (i.e., after deducting the interest expense).

The CRA did not attempt to apply subsection 74.5(11), an anti-avoidance provision (entitled Artificial Transactions) contained within the attribution rules. It provides that the attribution rules do not apply when it may reasonably be concluded that one of the main reasons for a property transfer that is otherwise subject to the attribution rules is to reduce the amount of tax that would be payable on the income and gains derived from the property. If the CRA had applied this provision instead of GAAR, the interest expense would have been deductible against the dividend income received, but in Mrs. Lipson's hands, not in Mr. Lipson's.

Therefore, the result of the reassessments was that neither Mr. Lipson nor Mrs. Lipson could deduct the interest expense. The CRA asserted that GAAR should apply because the purpose of the series of transactions was to borrow money to purchase the house, not to acquire the shares.

The Issue

The taxpayer admitted that there had been a "tax benefit" and an "avoidance transaction," but argued that GAAR could not apply because the requirement in subsection 245(4) was not fulfilled. That provision states that GAAR can be applied only if it may reasonably be considered that the transaction in question would result directly or indirectly in a misuse of the provisions of the Act or in an abuse having regard to the provisions of the Act read as a whole.

Lower Court Decisions

The Minister of National Revenue was successful in both the Tax Court (2006 DTC 2687) and the Federal Court of Appeal (2007 DTC 5172). Chief Justice Bowman (now retired from the Tax Court, but the judge who had ruled against Mr. Singleton at the Tax Court level in **John R.**

Singleton v. The Queen 96 DTC 1850)[5] held that the series of transactions resulted in a misuse of all the provisions relied on, because they were carried out for the purpose of making interest deductible on borrowed money used to buy a residence.

The Federal Court of Appeal upheld this decision, finding that the Tax Court judge was entitled to take into account the purpose of the series of transactions in determining whether any of the transactions in the series resulted in an abuse.

The Supreme Court of Canada Decision

The majority decision finds that to allow the attribution rules to operate to reduce Mr. Lipson's income by allowing him the benefit of the interest deduction was an abuse of those rules and that GAAR should therefore apply.

The reasons for the majority's decision are important. The decision states that if Mr. Lipson had simply sold shares of LipsonCo to his spouse and she had claimed an interest deduction on money borrowed to acquire these shares, the transactions would have been "unimpeachable." The provisions of paragraph 20(1)(c) and subsection 20(3) had not been misused or abused.

However, the transactions became "problematic" when the Lipsons turned to subsection 73(1) (the spousal rollover) and subsection 74.1(1) (the attribution rule) to obtain the result of shifting the interest deduction to Mr. Lipson. To allow subsection 74.1(1) to be used to reduce Mr. Lipson's income tax from what it would have been without the transfer of shares to his spouse would frustrate the purpose of the attribution rules and GAAR was properly invoked by the Minister. The decision characterizes the attribution rules as, themselves, anti-avoidance rules, which were being used to facilitate abusive tax avoidance.

The majority for the most part applies the GAAR guidelines as established in the Supreme Court of Canada's previous GAAR decisions[6] in reaching the conclusion that the benefit of the attribution of Mrs. Lipson's interest expense could be denied to Mr. Lipson under the GAAR because to allow him this deduction would frustrate the object, spirit or purpose of these provisions.

Somewhat curiously, although the Minister had approached the assessment by disallowing the interest deduction altogether, and simply adding the gross dividends on the LipsonCo shares held by Mrs. Lipson to Mr. Lipson's income, the majority decision states that even though the dividends should continue to be attributed to Mr. Lipson, the interest deduction should be allowed to Mrs. Lipson. Since it is not disclosed in the reasons whether Mrs. Lipson had income against which to claim this deduction, and, in any event, her tax return was not in issue in the appeals, it isn't clear what the practical effect of this part of the decision is for her. But for taxpayers in her situation who have other income sources, the allowance of the interest deduction to the spouse is welcome. The Minister's failure to convince the majority to deny the interest deduction to both Mr. and Mrs. Lipson can therefore be considered a significant loss on a central part of the Minister's case.

Upholding the assessment of the dividends in the hands of Mr. Lipson but indicating that Mrs. Lipson should be allowed the interest deduction does seem at odds with the majority's conclusion that GAAR should apply because the attribution rules had been misused. With all due respect, one might be forgiven for thinking that if the attribution rules were frustrated if they operated to attribute the interest expense to Mr. Lipson, then a more consistent recharacterization of the tax consequences would have been to leave both the dividends and the interest in the hands of Mrs. Lipson.

With respect to whether the Tax Court judge had been correct in attributing the weight he did to the "overall purpose" of the transactions, the majority does seem to have agreed with the taxpayers that the Tax Court judge's approach was not entirely consistent with the guidelines established in **Canada Trustco** and **Kaulius**, at least to the extent that he based his conclusion that GAAR applied on an assessment of the taxpayer's motivation, "true economic purpose" or the "economic substance" of the transactions. The majority states that "there is no question that a court may consider a series of transactions of which the transaction is a part in order to determine whether the transaction results in abuse and misuse of one or more provisions of the Act." Motivation, purpose and economic substance are relevant to the misuse or abuse analysis, but only to the extent that they

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5. Overturned on appeal to the Federal Court of Appeal, 99 DTC 5362, and also decided in favour of the taxpayer at the Supreme Court of Canada level, 2001 DTC 5533.
6. ***The Queen v. Canada Trustco Mortgage Co.***, 2005 SCC 54 and ***Kaulius v. The Queen* (*sub nom Mathew v. Canada*)**, 2005 SCC 55

establish whether the transaction frustrates the purpose of the relevant provisions.

Where the majority perhaps diverged from the previously established guidelines (although it is not clear whether it did so consciously) was in its approach to the onus imposed on the Minister to establish that the planning was clearly abusive. As pointed out by Binnie J. in his dissenting judgment, the Court had stated in **Canada Trustco** that if the existence of abusive tax avoidance is unclear, the benefit of the doubt goes to the taxpayer. The majority stated that the burden was on the Minister to prove, on the balance of probabilities, that the avoidance transaction results in abuse and misuse and, without a great deal of discussion of how the Crown had met that onus, concludes that the attribution rules had been misused or abused because their object, spirit and purpose had been frustrated.

A further point dealt with in the decision was the significance of the specific anti-avoidance rule contained within the attribution rules, namely subsection 74.5(11). The Minister had not based the reassessment on this provision and both parties had agreed for purposes of the appeal that its application was not in issue. The argument was advanced that the Court should refuse to apply GAAR given that there was another more specific anti-avoidance rule. The majority refused to consider whether the taxpayers could have succeeded under that rule. The majority clearly holds that GAAR is a residual provision that can apply even if the transaction falls outside the scope of a more specific anti-avoidance provision. In other words, the fact that a specific anti-avoidance rule exists is not conclusive that transactions not within the scope of that rule that are not subject to scrutiny under GAAR.

The majority decision was written by LeBel J. and concurred in by three other justices. That LeBel J. was the author of the decision (or that he held against the taxpayers) is not surprising, given that he would have found against the taxpayer in the **Singleton** case.[7]

In the **Singleton** case, the court held that planning by an individual to, in effect, convert non-deductible interest expense on a home mortgage into deductible interest expense was acceptable. In that case, Mr. Singleton, a lawyer, withdrew capital from his law firm and used the capital to acquire a house. On the same day, he borrowed from a bank to replace the capital in his firm. While the Tax Court of Canada ruled against him, both the Federal Court of Appeal and the Supreme Court of Canada held that he could rely on paragraph 20(1)(c) to deduct the interest expense, as the borrowing was directly traceable to the replacement of the capital. However, **Singleton** was not a GAAR case.

Arguably, the Lipsons' planning had similarities to the steps taken by Mr. Singleton, the only differentiating factor being that two taxpayers (spouses) rather than one, were involved in the Lipson planning and the attribution rules were also relied on.

Therefore, the question remains whether planning of the "Singleton" type is still acceptable. In argument at the Supreme Court of Canada, the Crown had conceded that it did not claim that the GAAR would have applied on the facts of that case. In Binnie J.'s dissenting judgment (concurred in by Deschamps J.) in **Lipson**, he clearly assumes that the Singleton planning would not be found to be subject to GAAR and concludes that the Lipson planning, which he characterized as Singleton with a "spousal twist," should similarly not be found to be abusive tax avoidance. He could not reconcile the majority's conclusion that the interest deduction per se was not abusive, with its conclusion that the plan became abusive with the addition of a spousal rollover that operated precisely as it was intended by Parliament to operate.

In the majority reasons, LeBel J. sidesteps the question of whether the **Singleton** case is relevant to the Lipson planning, by noting that neither GAAR nor the attribution rules was at issue in **Singleton**. He also states that applying paragraph 20(1)(c) and its "direct use" test involves an inquiry that is distinct from the inquiries that must be made under section 245 (GAAR). Although the Court was urged to find for the Lipsons on the basis that to find otherwise would introduce undesirable uncertainty into tax planning, the majority decision states that uncertainty is inherent, because the GAAR analysis always requires consideration of the unique facts. While it is neither a penal provision nor a "hammer to pound taxpayers into submission" it is designed to restrain abusive tax avoidance.

The second dissenting opinion was delivered by Rothstein J., who agreed with the reasoning of the majority and of Binnie J. that GAAR did not apply with respect to the use of paragraph 20(1)(c) and subsection 20(3). This is not surprising, given that Rothstein J. had, while on the Federal Court of Appeal, written the majority

7. LeBel J. wrote a dissenting opinion in the **Singleton** case, concurred in by Bastarache J. (now retired).

decision in **Singleton**, in favour of Mr. Singleton. However. Rothstein J.'s conclusion that GAAR did not apply in respect of the use of the attribution rules was based on his view that the plan should have been found to fail because of the specific anti-avoidance rule contained in subsection 74.5(11). Rothstein J. noted that if the Minister had applied this rule, the result would have been different because both the dividends and the interest would have remained with Mrs. Lipson rather than being attributed to Mr. Lipson. In Rothstein J.'s view, the Minister should only be able to resort to GAAR when he has no other recourse and in this case the proper recourse should have been to subsection 74.5(11). The view that it was open to the Court to base its conclusion on subsection 74.5(11) applying was rejected by the other members of the Court.

Other Implications?

Altogether, it is difficult to state with certainty what has been added to the jurisprudence on the GAAR by this decision, not least because of the division in the Court and the unusual number of opinions.

The CRA has indicated on past occasions that following release of the decision in **Lipson** it may have to revisit its position on the Singleton-type planning, and other types of planning techniques, such as "cash damming," a technique that today is endorsed as acceptable in Interpretation Bulletin IT-533 (Interest Deductibility and Related Issues).

Our view is that nothing in the **Lipson** decision justifies any change in the CRA's previously established positions set out in IT-533 and elsewhere. Nothing in the majority decision deals with the type of planning undertaken in **Singleton**, which involved a single taxpayer arranging his affairs to maximize interest deductibility. The majority reasons in **Lipson** make it clear that the narrow focus of the analysis, and the reason for concluding that GAAR applied, was the introduction of the attribution rules into the planning. Both dissenting judgments are emphatic that planning to finance personal assets out of equity and income earning assets out of borrowed funds is acceptable tax planning and nothing in the majority decision contradicts this.

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