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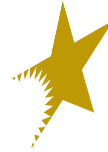
EXPECT THE BEST

Supreme Court Has Good News and Bad News on Tax Avoidance

by Paul Schnier
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Readers of Blaneys on Business may recall that, in December, 2005, we wrote about the Supreme Court of Canada's position with respect to the general rule that prohibits people from arranging their affairs specifically so that they can avoid tax. This rule is called the general anti-avoidance rule, or GAAR.

At that time the Court had rendered decisions in two cases concerning the application of the GAAR to tax avoidance transactions. We had hoped that further jurisprudence would help clarify where the line is drawn between what the courts will consider legitimate tax planning versus what it will consider abusive tax avoidance. In the recent Lipson case the Supreme Court of Canada has done just that with regard to the specific case in question. It has not, however, provided clarity as to where the line will be drawn in future cases.

The facts of the Lipson case are fairly simple: Mrs. Lipson borrowed $562,500 from a bank in order to finance the purchase from Mr. Lipson of some shares in a family holding company. This transaction was completed.

At the same time the Lipsons used the borrowed money, together with additional monies, to buy a home for $750,000. On the closing of the home purchase, the Lipsons took out a mortgage of $562,500 on the security of the home and used this money to repay Mrs. Lipson's original bank loan.

When you transfer property to any relative except your spouse, the *Income Tax Act* deems that the transfer has taken place at fair market value. If fair market value is different from the value of the property when it was acquired originally, a capital gain or capital loss will arise and you will have to deal with the tax consequences accordingly.

When you transfer property to your spouse, however, the *Income Tax Act* deems that a "rollover" has been made *not* at fair market value, but at the original value. In other words, there no gain or loss associated with the transaction. If, as and when your spouse realizes a gain or loss, it is attributed back to you for income tax purposes.

This normal spousal rollover provision takes effect automatically unless, as the Act permits, you explicitly elect to opt out. If you do opt out, the transfer is deemed to have taken place at fair market value and you absorb its tax consequences. Any tax consequences after that belong to your spouse.

The Lipsons did *not* file such an election under the provisions of the *Income Tax Act*. The result was that no gain or loss was recognized by Mr. Lipson on the sale of his shares in the family holding company to Mrs. Lipson. As a consequence of not electing out of this spousal rollover, a loss (arising

from the fact that the interest expense on the loan was greater than the dividend income on the shares) was attributed to Mr. Lipson. He claimed this loss on his income tax return. The Canada Revenue Agency (CRA) disallowed this loss under the GAAR and it was this disallowance that was the subject of the Supreme Court of Canada decision.

The specific provisions of the Act applicable to this transaction yield the following results:

1. Mrs. Lipson is allowed to deduct the interest expense on her original borrowing since the loan was used for the purpose of purchasing an income-producing asset.

2. Interest on the mortgage is deductible since the money was used to repay a loan, the interest on which was originally deductible.

3. Because the parties were content to have the spousal rollover provisions apply with respect to the share sale, the attribution provisions of the Act require Mr. Lipson to report on his tax return any income or loss with respect to the shares.

The CRA's position was that the Lipsons, in essence, used the provisions of the Act to manipulate the interest on a loan used to purchase a home into a tax deduction for Mr. Lipson. The Supreme Court of Canada in a four to three decision (with two very strong dissenting opinions) largely agreed with this position, the justification being that the use of the attribution provisions of the Act to generate a tax deduction for Mr. Lipson in these circumstances constituted abusive tax avoidance.

So what's the good news?

The good news is that, up until the "spousal twist," the Supreme Court of Canada had no difficulty with the transaction. There would have been no problem with Mrs. Lipson claiming the interest deduction on the mortgage and the Court confirmed its earlier decision in the Singleton case which stands for the proposition that we are entitled to organize our affairs so that borrowed money is used for the purpose of acquiring income producing assets and other cash is used for the purpose of acquiring non-income producing assets so long as a tracing can be established.

In the Singleton case the taxpayer withdrew his capital account in a partnership of which he was a member and used the money to purchase a home. He then borrowed money to replace his capital account and the interest deduction on this borrowed money was allowed.

Where the majority drew the line in this case, which is essentially the same as the Singleton case, was with the use of the attribution provisions of the Act to allow Mr. Lipson to claim the interest deduction.

And now for the bad news.

In our view the bad news is twofold. First, the line between legitimate tax planning and abusive tax avoidance is as ambiguous as ever. We cannot understand why the mere operation of the attribution provisions of the Act would have been sufficient to have this transaction fall under the GAAR. The Lipsons did nothing to cause the attribution provisions to apply. They did not chose to have the share sale generate capital gains for Mr. Lipson, a choice that would have required a positive action on their part. By not taking this action, the attribution provisions applied automatically.

Why, then, would what is acknowledged to be a perfectly legitimate transaction turn into abusive tax avoidance merely because they were content with the application of specific provisions of the Act?

Unfortunately, the Court gives us no explanation for this and thus, no help on where the line will be drawn in future cases.

Second, the CRA will undoubtedly chalk this case up as a clear victory and threaten to apply the GAAR in a myriad of situations in the future in order to gain taxpayer acquiescence. Once again, how could anyone confidently say to them that the GAAR will not apply?

We concluded our earlier article by suggesting that "paper transactions" would likely be subject to the GAAR while real commercial transactions (albeit with associated tax benefits) would survive. We cannot be so sure any more. ■