

New Supreme Court Ruling on GAAR – Dissecting the Lipson Decision

On Thursday, January 8, 2009, the Supreme Court of Canada released its decision in the *Lipson* case dealing with the application of the general anti-avoidance rule (GAAR) under the *Income Tax Act*. The tax community has been anxiously awaiting the outcome in *Lipson* since it was heard in April of last year. Not surprisingly, given that the Court took eight months to release its ruling, two separate dissenting judgments were delivered, reflecting a difference of opinion within the Court.

The *Lipson* case goes to the heart of a taxpayer's right to arrange his or her affairs so as to pay the least amount of tax (which is generally referred to as the "Duke of Westminster" principle after an English case heard in the 1930's). Mr. and Mrs. Lipson carried out a series of transactions which included the purchase of a new home. On the day prior to the closing date, Mrs. Lipson borrowed money from a bank to purchase common shares of a private family company held by her husband, who then applied those funds to the purchase of the home. By prearrangement, a new mortgage loan was taken out on the security of the home (which was held in joint names) and immediately used to repay Mrs. Lipson's share purchase loan.

The taxpayers relied on subsection 20(3) of the *Income Tax Act* for the proposition that the mortgage financing, having been applied to repay the share purchase loan, was deemed to have been used for the same eligible purpose as the share purchase loan, with the interest thus being deductible. In addition, as the taxpayers did not elect out of the automatic spousal rollover on the sale of the shares, the attribution rule in section 74.1 of the Act applied automatically to attribute any income or loss from the transferred property (i.e. the shares) from Mrs. Lipson back to Mr. Lipson. In 2 of the 3 years under appeal, a loss resulted as the interest expense exceeded dividends paid on the shares, whereas in the third year, dividends exceeded the interest expense and net income was attributed to Mr. Lipson.

The ability to rearrange one's affairs in such a manner so as to convert non-deductible interest into deductible interest was the subject of an earlier decision of the Supreme Court in *Singleton*. In that case, Mr. Singleton, a lawyer, borrowed to replenish the capital in his law firm, on the same day that he withdrew capital for the purpose of purchasing a house. Judge Bowman in the Tax Court of Canada initially held that the "true economic purpose" of the transactions was to finance the purchase of a home, such that the interest was not deductible. Shortly after the Tax Court decision in *Singleton* was released, Mr. and Mrs. Lipson were reassessed on the same basis, namely that the interest expense claimed by Mr. Lipson was not deductible as it was, in essence, interest on money borrowed to purchase a home.

Subsequently, the Federal Court of Appeal and the Supreme Court of Canada found in favour of Mr. Singleton, reversing the decision of the trial court judge, and affirmed that, on a direct

tracing approach, the interest on his restructured borrowings was eligible for a deduction under paragraph 20(1)(c) of the Act. The GAAR was not an issue in the *Singleton* case. As a result of these reversals, the Minister changed his assessing position in *Lipson*, to deny the interest deductibility on the basis of GAAR, alleging a misuse or abuse of not only subsection 20(3) and paragraph 20(1)(c), but also the spousal attribution rules.

The hearing at the Tax Court of Canada in *Lipson* was held before (now) Chief Justice Bowman, who purported to follow the approach to the interpretation and application of GAAR set out by the Supreme Court in the *Canada Trustco* and *Kaulius* cases. Chief Justice Bowman dismissed the taxpayer's appeal on the basis that "the overall purpose as well as the use to which each individual provision was put was to make interest on money used to buy a personal residence deductible". The Federal Court of Appeal's analysis concluded that, notwithstanding that none of the impugned sections of the Act appeared to have been misused in isolation, nonetheless the series of transactions viewed as a whole could be viewed as a misuse or abuse of the Act.

Mr. Justice Lebel delivered the majority judgment for the Supreme Court, and distinguished *Lipson* from *Singleton* on the basis that neither GAAR nor the attribution rule was at issue in *Singleton*. In following the analysis mandated by the Court's decision in *Canada Trustco*, the majority queried what Bowman C.J.T.C. meant by "overall purpose" and affirmed that the taxpayer's motivation in carrying out a series of transactions is only relevant to the extent that it may establish whether the series frustrated the object and spirit, and therefore resulted in an abuse or misuse, of one or more provisions of the Act.

In Mr. Justice Lebel's view, the borrowing by Mrs. Lipson to purchase her husband's shares, and the use of those proceeds to purchase the residence, were "unimpeachable" insofar as interest deductibility is concerned. However, it became "problematic" when the parties took further steps to invoke the operation of the spousal attribution rules, notwithstanding that they were triggered automatically. In the majority's view, the purpose of the attribution rules (i.e. to prevent spouses from reducing tax when transferring property between themselves) was frustrated since, before the share transfer, no interest expense could have been claimed by Mr. Lipson to reduce the dividend income in his hands, whereas the operation of the attribution rule allowed Mr. Lipson to reduce his income with the loss attributed from his spouse. In the result, although the dividend income on the shares remained taxable to Mr. Lipson, the majority judgment attributed the interest deduction back to Mrs. Lipson, thereby splitting the revenue and expense from the transferred property, notwithstanding that the Act speaks only of attributing the income or loss from the property on a net basis.

The dissent delivered by Mr. Justice Binnie asked the question "How healthy is the Duke of Westminster? There is cause for concern." In Mr. Justice Binnie's view, the spousal "twist" added to *Singleton* "should not cause the entire series of transactions to be characterized as abusive. After all there is nothing in the Act to discourage the transfer of property at fair market value between spouses." The minority points out that if the interest deduction per se is not found to be abusive, it should not become abusive merely by the addition of a spousal rollover which operates precisely as it was intended by Parliament to operate. To hold otherwise is to further blur the distinction under the GAAR between tax avoidance and abusive tax avoidance.

Mr. Justice Rothstein delivered his own dissenting judgment, holding that subsection 74.5(11), the specific anti-avoidance provision with respect to the attribution rules, acted to pre-empt the application of GAAR, since GAAR is only to apply to a transaction or a series of transactions where the Act would otherwise permit the tax benefit sought to be obtained by the taxpayer. Mr. Justice Rothstein would have applied the specific anti-avoidance rule, so as to leave both the dividend income and the interest expense in the hands of Mrs. Lipson, on the basis that one of the main reasons for the transfer was to reduce the amount of tax that would, but for subsection 74.5(11), be payable on the income derived from the property. None of the other Justices, however, were prepared to apply the specific anti-avoidance rule since it had not been put in issue nor argued by either party.

In the result, although Mr. Lipson's appeal was dismissed, taxpayers in general may take some comfort from the Court's reaffirmation of the right to structure or restructure financing transactions to result in an eligible use of borrowed funds to support interest deductibility. Some uncertainty remains: the Court acknowledged that "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. The GAAR is neither a penal provision nor a hammer to pound taxpayers into submission. It is designed to restrain abusive tax avoidance and to make sure that the fairness of the tax system is preserved. A desire to avoid uncertainty cannot justify ignoring a provision of the ITA that is clearly intended to apply to transactions that would otherwise be valid on their face."

With respect, it is by no means clear that GAAR was intended to apply to the facts in *Lipson*, on the basis of misuse or abuse of a provision of the Act which operated precisely as intended by Parliament. Query whether Mr. Lipson would have been reassessed to deny the interest expense, had the series of transactions not included the purchase of the home, given that the CRA clearly viewed the "abuse" as the deduction of interest on mortgage financing to acquire a personal residence. In a similar vein, would the series have been viewed as equally offensive if the roles of Mr. and Mrs. Lipson in the share sale had been reversed? Regardless of whether income or loss is attributed to the higher or lower income spouse, the end result is the creation of an interest expense which would not have existed otherwise, but for the transfer. Given the logic behind the majority judgment, attribution of a loss to a lower income spouse could also be viewed as an abuse or misuse of the attribution rule. Perhaps the only certainty is that any transaction involving a transfer between spouses will now come under greater scrutiny.

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