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Update

Tax Law

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Supreme Court of Canada Releases New Decision on GAAR

On January 8, 2009, the Supreme Court of Canada released the highly anticipated decision of *Lipson v. Canada* ("**Lipson**"). *Lipson* is essentially the second Supreme Court of Canada decision to address the application of the General Anti-Avoidance Rule ("**GAAR**") contained in the *Income Tax Act* (Canada) (the "**Act**"). *Lipson* dealt with the deduction of interest in the context of borrowings used directly to acquire income producing property where the proceeds are effectively used to purchase non income producing property. Although an earlier decision of the Supreme Court in *Singleton v. Canada*[1] held that somewhat similar transactions were permissible under the Act, the application of GAAR was not considered in that case. While the Supreme Court of Canada in *Lipson* ultimately found in favour of the Minister of National Revenue (the "**Minister**") (in a 4:3 split decision) the reasons delivered by LeBel, J. on behalf of the majority can be regarded as being favourable to taxpayers in several respects. The general facts of the case are below.

Mr. Lipson and his wife entered into an agreement of purchase and sale for a new house. Mrs. Lipson borrowed $562,500 from a bank and used the funds to purchase shares of a family holding company from Mr. Lipson. The funds were then used to purchase the house. Mr. and Mrs. Lipson obtained a mortgage of $562,500 from the bank, the proceeds of which were used to fully repay the first loan advanced to Mrs. Lipson. By virtue of the application of the spousal attribution rules contained in the Act, the dividend income from the shares of the holding company that would have been included in Mrs. Lipson's income and the interest deductions that would otherwise have been available to Mrs. Lipson were attributed to Mr. Lipson. The Minister challenged the deduction of interest by Mr. Lipson on the basis that the series of transactions constituted a tax avoidance series that misused or abused provisions of the Act and was subject to GAAR. The Minister was successful at both the Tax Court of Canada and the Federal Court of Appeal.

The majority of the Supreme Court held that the series of transactions was abusive and that GAAR applied. As a result, the Court disallowed the interest deductions claimed by Mr. Lipson but attributed those deductions back to Mrs. Lipson.

The reasoning of the Court centred on the exploitation of the Act's spousal attribution rules. In short, the Court held that the attribution of Mrs. Lipson's interest deductions to Mr. Lipson resulted from the misuse of specific attribution rules. The Court held that Mr. Lipson's reliance on certain spousal attribution rules to achieve the intended result frustrated the purpose of the attribution rules and was subject to GAAR.

It is important to note that all seven judges in *Lipson* stated that interest on borrowed funds used to acquire income producing property, the proceeds of which are then used to purchase personal use property, is deductible for Canadian tax purposes. The Court therefore confirmed that the "tracing rules" of interest deductibility are still valid and that GAAR does not apply to re-characterize such transactions. However, it appears that relying on non-arm's length attribution rules in connection with interest tracing may result in abusive tax planning.

In addition, the Court confirmed that although taxpayers are generally still entitled to order their

[1] In *Singleton*, the taxpayer withdrew $300,000 of capital from his law firm partnership to purchase a house. He subsequently borrowed $300,000 from the bank to re-contribute capital to the law firm. In *Singleton*, the Supreme Court rejected the Minister's arguments and permitted the taxpayer to deduct the interest expense from his income.

affairs so as to minimize the amount of tax payable, the scope of permitted tax planning is to be restricted by GAAR. Additionally, the Court commented that although the application of GAAR may introduce a degree of uncertainty into tax planning, a desire to avoid uncertainty cannot justify ignoring a provision of the Act that is clearly intended to apply to transactions that would otherwise be valid on their face.

In summary, while the taxpayer's appeal in *Lipson* was dismissed, the reasons provided by the Court should keep taxpayers and tax planners relatively content. The reasons of the Court appear to be restricted to the specific facts of the case, and consequently, may not affect tax planning that does not utilize the same transactions. In fact, the comments made by the Court in respect of interest deductibility appear to bolster the validity of interest tracing and may afford taxpayers with additional tax planning opportunities.

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