



Lipson v. The Queen

The Supreme Court of Canada's Latest Interpretation of the General Anti-Avoidance Rule

[Kevin Fritz](#)
[Andrea Shreeram](#)

On January 8th, the Supreme Court of Canada ("SCC") released its eagerly anticipated decision in *Lipson v. The Queen* ("**Lipson**"). *Lipson* involved the application of the general anti-avoidance rule ("**GAAR**") to a tax avoidance scheme whereby a husband and wife structured their bank borrowings so as to effectively make the mortgage interest on their new home purchase tax deductible. The case is of particular importance, as it is only the third appeal in which Canada's highest court has interpreted the GAAR.

The Tax Court of Canada's application of the GAAR to this tax scheme attracted much attention in the Canadian tax community, as it potentially put at risk a common tax planning technique that had been accepted in the SCC's 2001 decision in *Singleton v. Canada*. *Singleton* was a pre-GAAR case, in which Mr. Singleton successfully made his mortgage interest tax deductible by first taking capital out of his law firm to purchase a new home and then borrowing from a bank in order to replenish his partnership capital account. The interest on this bank loan was held to be properly deductible.

In *Lipson*, a slim majority of the SCC held that the GAAR applied to deny the interest deduction to Mr. Lipson. However, the SCC was clear to distinguish the Lipson tax planning from the Singleton tax planning and expressed the view that the so-called "Singleton Shuffle" is still acceptable tax planning in Canada.

The GAAR

Before getting into the specifics of *Lipson*, it is helpful to briefly set out the requirements that must be met in order for the GAAR to be successfully applied to deny a tax benefit. In very general terms, the GAAR denies a tax benefit where three criteria are met: a tax benefit arises from a transaction; the transaction is an avoidance transaction; and the transaction results in an abuse and misuse of a provision of the *Income Tax Act* (Canada) ("**ITA**"). The taxpayer

bears the burden of proving that the first two of these criteria are not met, while the burden is on the Minister of National Revenue ("**Minister**") to prove that the avoidance transaction results in abuse and misuse.

In *Lipson*, only the abuse and misuse criterion was at issue, as it was admitted by Mr. Lipson that the first two criteria for a GAAR assessment were satisfied.

Lipson - The Facts

Mr. Lipson carried out a series of transactions whose purpose, he conceded, was to minimize his income tax. First, in April 1994, Mr. Lipson and his wife entered into an agreement of purchase and sale for a family residence in Toronto. The purchase price was \$750,000. On August 31, 1994, Mrs. Lipson borrowed \$562,500 from the Bank of Montreal to finance the purchase at fair market value of 20 and 5/6 shares in Lipson Family Investments Limited, a family corporation. Mrs. Lipson paid the borrowed money directly to her husband, who transferred the shares to her.

Mr. and Mrs. Lipson obtained a mortgage from the Bank of Montreal for \$562,500, which was advanced on the closing date of September 1, 1994. That same day, they used the mortgage loan funds to repay the share loan in its entirety.

Mr. Lipson relied on four provisions of the ITA to claim a deduction of the mortgage loan interest on his 1994, 1995 and 1996 tax returns. The first was s. 73(1), pursuant to which a taxpayer may defer tax on inter-spousal transfers of property. Mr. Lipson did not elect out of this provision, as he was entitled to do. As a result, the transfer of shares from him to his wife was deemed to have occurred at his adjusted cost base rather than at fair market value, such that he neither sustained a loss nor realized a gain on the sale.

Second, s. 74.1 attributes any income or loss from property transferred from one spouse to another back to the transferring spouse for tax purposes. Thus, although Mrs. Lipson owned the shares acquired from her husband, the dividend income and losses from the interest deductions were attributed to Mr. Lipson for income tax purposes.

The third provision was s. 20(3), which allows a deduction for interest on money borrowed to repay

previously borrowed money if the interest on the original loan is deductible. This allowed for the mortgage loan to be treated as having funded the share purchase by Mrs. Lipson rather than the home purchase.

Finally, Mr. Lipson deducted the interest on the mortgage loan pursuant to s. 20(1)(c), which permits the deduction of interest on money borrowed “for the purpose of earning income from a business or property”.

On his 1994, 1995 and 1996 tax returns, Mr. Lipson deducted the interest on the mortgage loan and reported the taxable dividends on the shares as income where applicable. The Minister disallowed the interest expenses of \$12,948.19, \$47,370.55 and \$44,572.95, respectively, for those years and reassessed Mr. Lipson accordingly. The Minister argued the case on the basis of the GAAR and submitted that the series of transactions amounted to abusive tax avoidance.

Tax Court of Canada Decision

Mr. Lipson appealed the Minister’s reassessments to the Tax Court of Canada. The only issue at trial was whether the transactions, which the parties agreed were avoidance transactions resulting in a tax benefit, constituted abusive tax avoidance and were prohibited by the GAAR. Bowman C.J.T.C. held that “[t]he 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”. He emphasized this “overall purpose” in relation to the purposes of each of the provisions in question and found that the series of transactions resulted in a misuse of ss. 20(1)(c), 20(3), 73(1) and 74.1 of the ITA.

Federal Court of Appeal Decision

On appeal, Mr. Lipson argued that Bowman C.J.T.C. had erred in his decision by relying on the “overall purpose” of the series of transactions (namely, making the mortgage interest deductible) in concluding that the transactions resulted in a misuse of specific ITA provisions. They claimed that the proper approach in applying the GAAR would have been to assess each transaction, and the resulting legal relationships, separately, in which case the court could find no abuse and misuse of the provisions themselves, as they had been used specifically as intended by the ITA.

A unanimous Federal Court of Appeal held that, viewed separately and without regard to the overall purpose of the scheme, none of the Lipsons’ transactions appeared abusive. However, the Court

concluded that Bowman C.J.T.C. was entitled to consider the transactions as a series. The decision stated that “the series cannot be ignored in conducting the abuse analysis” for the purposes of the GAAR and that it had been open to Bowman C.J.T.C. to find, as he did, that the transactions resulted in a misuse of several provisions of the ITA.

Supreme Court of Canada

At the SCC, the majority decision (written by LeBel J.) held that the Lipsons’ transactions constituted abusive tax avoidance and applied the GAAR to deny the interest deduction. However, the reasons used to come to this conclusion differed somewhat from those of the earlier court decisions.

In addressing Mr. Lipson’s main argument, LeBel J. agreed that in making the abuse or misuse determination, it was improper to look at the taxpayer’s motivation or “overall purpose” of the transactions in question. Rather, in determining whether a section of the ITA had been abused or misused, the court must consider the “overall result” of the transactions. In other words, the result of the transactions must be considered in assessing whether the purpose of a particular section of the ITA has been frustrated. One might ask whether this is a distinction without a difference, as the result should be the same as the purpose if the series of transactions is properly implemented. However, this may not always be the case.

LeBel J. went on to hold that ss. 73(1) and 74.1 of the ITA (but not ss. 20(1)(c) and 20(3)) were misused and abused by the Lipsons and that the GAAR was applicable. In coming to this conclusion, he found that the purpose of s. 74.1 was to prevent spouses from reducing tax by taking advantage of their non-arm’s length relationship when transferring property between themselves. He wrote that “to allow s. 74.1(1) to be used to reduce Mr. Lipson’s income tax from what it would have been without the transfer to his spouse would frustrate the purpose of the attribution rules. Indeed, a specific anti-avoidance rule is being used to facilitate abusive tax avoidance.”

In a strongly worded dissenting opinion, Binnie J. placed great emphasis on the *Singleton* decision and specifically on the fact that if that tax planning was not objectionable under a GAAR analysis then the Lipsons’ planning should also be acceptable. In terms of his legal analysis to support this conclusion, he differed from LeBel J. on two important points. First, he repeated the SCC’s earlier pronouncement on the GAAR, that the Minister must show that the abusive nature of the transaction is “clear”. LeBel J., on the other hand, had said that the Minister must prove abuse or misuse on a “balance of probabilities”, a

seemingly lower standard of proof. Second, Binnie J. disagreed with LeBel J.'s assessment of the purpose of the attribution rules in ss. 73(1) and 74.1 and did not view their purpose as being offended by the Lipsons' tax reduction scheme.

In separate dissenting reasons, Rothstein J. took the position that the Mr. Lipson's tax deduction should have been denied pursuant to a different section of the ITA and that the GAAR did not need to be relied upon.

Conclusions

In summary, the *Lipson* decision demonstrates the difficulty that courts have in applying the GAAR, even to a relatively simple set of facts. The case was heard by three levels of court and 11 judges. Five separate judgments were given with differing reasons; however, all but two of the judges ultimately denied the tax deduction to the Mr. Lipson.

It also demonstrates the critical importance, and somewhat subjective nature, of the abuse and misuse assessment under GAAR. The key distinguishing feature between *Lipson* and *Singleton* appears to be that in *Lipson*, the majority of the SCC found that the purpose of the attribution rules in ss. 73(1) and 74.1 of the ITA was frustrated; whereas in *Singleton*, no specific provision of the ITA was considered to have been abused or misused. However, in both cases the ultimate purpose of the series of transactions was to make mortgage interest payments tax deductible. Clearly, the devil is in the details when considering the application of the GAAR.

Ultimately, the assessment of the legislative purpose of an ITA provision is the key to a GAAR determination. However, the disconnect between the majority and the minority decisions of the SCC in *Lipson* demonstrates that the purpose behind particular provisions of the ITA and whether that purpose has been frustrated is sometimes in the eye of the beholder.

This update is intended as a summary only and should not be regarded or relied upon as advice to any specific client or regarding any specific situation.

If you would like further information regarding the issues discussed in this update or if you wish to discuss any aspect of this commentary, please feel free to contact us.

Wildeboer Dellelce LLP

Wildeboer Dellelce Place
365 Bay Street, Suite 800
Toronto, ON M5H 2V1
Phone: (416) 361-3121
Fax: (416) 361-1790

72 Victoria Street South, Suite 401
Kitchener, Ontario N2G 4Y9
Phone: (519) 741-8708
Fax: (519) 741-9576



wildlaw.ca