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In this edition of the Canadian Tax Planners Newsletter, we shall review the recent Supreme Court decision in the Lipson case, in which the taxpayer went through a number of complex steps in order to receive a tax deduction for mortgage interest paid on his personal residence. We shall also review the use of trusts to achieve various personal financial objectives.

Supreme Court Decision in Lipson v the Queen

The Lipson case is considered one of the most important tax cases in recent years. Before reviewing the details of the case, it is important to understand the concept of the general anti avoidance section of the Income Tax Act. An avoidance transaction is defined as any transaction that directly or indirectly results in a tax benefit, unless the transaction may reasonably be considered to have been undertaken for a bona fide purpose, other than to obtain a tax benefit. Although this is a powerful audit tool for CRA, there have been few successful cases utilizing the general anti avoidance rule, as the courts allow individuals to arrange their affairs to pay the least amount tax, assuming they have not violated the tax rules.

In the Lipson, case, the taxpayers use a complex series of transactions in order to receive a tax deduction for interest payments on their personal mortgage. The steps taken by Lipson family to receive a deduction for their mortgage payments can be summarized as follows:

- Mrs. Lipson borrowed over \$500,000 and used the funds to purchase shares in her husband's investment company. Since the sale was between spouses, Mr. Lipson chose to have the transaction occur at the original cost, so that no capital gain would be generated
- this money was used to purchase a principal residence owned by both spouses
- the couple then borrowed the same amount which was secured by a mortgage on the house that was just purchased
- the newly borrowed money was used to repay the loan originally taken out by Mrs. Lipson to purchase shares in her husband's company
- Mr. Lipson allowed the attribution rules to apply

The taxpayer believed the interest was deductible since the funds were used to repay a loan and interest on that loan would be deductible. Despite the fact that each of the steps

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taken by the Lipsons was legal and consistent with the provisions of the Income Tax Act, Mr. Lipson was reassessed by CRA. After losing his appeal in the Tax Court of Canada and the Federal Court of Appeal, The Supreme Court of Canada ruled by a vote of four to three against Mr. Lipson. This was good news/bad news decision. Although bad news for the specific taxpayer as the Court applied the general anti avoidance rule, the ruling should be considered good news for other taxpayers. In their decision the judges accepted the tax planning tactic of transferring debt between assets in order to maximize a taxpayer's claim for interest expense. As it appears that the general anti avoidance rule will not be used against asset transfer strategies.

Let's review two examples where this may benefit taxpayers.

Mortgage Transfer Strategy

- an individual owns a home that has a \$50,000 mortgage
- he also owns \$50,000 of stock and debt was not used to purchase these shares
- the taxpayer sells the stock and pays off the mortgage. The individual borrows \$50,000 and repurchases the stock. If there was a loss on the shares, the taxpayer would normally wait at least 30 days to avoid the superficial loss rules

The result is the debt is attached to the investments and not the mortgage. Thus, the interest is now deductible for income tax purposes. This strategy will not be successful unless it is properly documented.

Personal Loan Strategy

An individual has \$40,000 in a chequing account and is considering the purchase of a vehicle costing \$40,000 or using the funds to purchase shares. After weighing the alternatives of a vehicle vs. the investment, the individual decides to purchase both the automobile and the stock. Unfortunately, with only \$40,000 of available cash, a loan is required. This provides a basic tax planning opportunity. If the cash is used to purchase the vehicle and funds are borrowed to purchase shares, the interest on the investment loan is deductible. If the individual used the available funds to purchase the stock and applies for a car loan, the interest on the loan would not be deductible.

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