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2009-04-01

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Delivery Details

Date: January 8, 2019 at 3:15 p.m.
Delivered By: VERN KRISHNA
Client File: GAAR

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Line Between Planning and Tax Abuse Unclear
Date: April 1, 2009
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Tax law is complex and, therefore, uncertain. Legislative volume promotes uncertainty and the Income Tax Act is nothing if not voluminous—2,000 pages and growing.

Taxpayers are entitled to plan to reduce their taxes provided they do not violate the legislative purposes of the Income Tax Act and Canadian tax treaties. The line between legitimate tax planning and abusive tax avoidance is far from clear and legal professionals should carefully evaluate transactions in legal opinions.

The Supreme Court of Canada's decision in Lipson illustrates the risks inherent in tax planning. The underlying facts of the case were as follows. The Lipsons (Earl and Jordana) purchased a family residence. To ensure the interest on their mortgage was deductible for tax purposes, they engaged in a three-step series of transactions.

First, Jordana Lipson borrowed $562,500 from a bank to purchase shares in her husband's family investment corporation at their fair market value. Since Jordana used the borrowed money to purchase investment assets, the interest payable on the demand note was deductible for tax purposes.

Second, the taxpayers obtained a mortgage loan from a bank for $562,500. Jordana used the mortgage funds to repay the share-purchase loan from the bank. As the home-mortgage loan substituted for the share-purchase loan, Jordana could deduct the interest on it for tax purposes.

Pursuant to the income-attribution rules, any dividend income (net of interest expenses) on Jordana's shares would be taxable in Earl's hands. As Earl was the higher-income taxpayer, the arrangement would, in economic terms, allow the higher-income taxpayer to deduct the home-mortgage interest.

Each step in the series of transactions was legal and proper. The Income Tax Act specifically allowed or dictated the consequence of each step in the series of transactions. The central question in the case was the appropriate balance between the Westminster principle and the general anti-avoidance rule (GAAR) in the Income Tax Act.

The Westminster principle allows taxpayers to arrange their affairs so as to legally minimize the amount of tax payable. The Lipsons clearly met the Westminster test on all counts by satisfying the technical requirements of each statutory provision.

The act allows spouses to roll over capital assets to each other without triggering any immediate income tax liability. For

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example, if a husband sells shares that cost $10 per share to his wife for $25 per share, the act deems the transaction to occur at $10 a share and there is no capital gain. The rationale from a policy perspective is that it is unfair to impose a tax on transactions that do not involve a fundamental economic change in ownership, even though there may be a change in form or legal structure.

Following the rollover, the transferee spouse assumes the transferor’s cost base for tax purposes—in the above example, $10 a share. If the transferee subsequently sells the shares to a third party, the act attributes any gain or loss to the transferor, who will have to pay tax on the gain as if he had not transferred the property in the first place. Thus, for limited purposes, the section treats spouses as an economic tax unit.

Another specific rule allows interest on a substituted business loan to be deductible if the original loan that it replaces was deductible. The rule facilitates commercial financing by allowing substitute refinancing.

However, a third rule—income attribution—provides that any income from the property that a taxpayer transfers to his spouse is attributed back to him for tax purposes. The purpose of the attribution rule is to prevent taxpayers from splitting income to reduce their marginal rates of tax. Thus, if the transferee sells the shares for $40 a share, the transferor is taxable on the entire capital gain of $30 a share.

Relying on the Westminster principle, the Lipsons arranged their affairs by using three different statutory rules to minimize their taxes. The Westminster principle, however, is not absolute and must be read in the context of GAAR.

GAAR requires a unified textual, contextual and purposive approach to statutory interpretation. One must determine the intention of the legislator by considering the text, context and purpose of the provisions at issue.

The Supreme Court held in a four-to-three decision—with two strong separate dissents—that the Lipsons abused the act. The purpose of the attribution rules is to prevent income shifting from high-marginal-rate taxpayers to lower-rate taxpayers within the family unit. The taxpayers misused the rule. The court disallowed the attribution of the interest expense to Mr. Lipson and, instead, allowed the deduction to his spouse—the lower-marginal-rate taxpayer in the family unit.

Tax planning stress tests taxpayer rights and legislative intention. Parliament legislated GAAR knowing that the new approach to tax law would create widespread, serious and unpredictable effects on legitimate tax planning. Thus, the only tax-planning rule that we can articulate with certainty—at least until we hear from a nine-bench court—is that Westminster prevails over GAAR, except in those circumstances where GAAR prevails over Westminster.

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