

# Tax Abuse

### COURT REPORT

BY JAMIE GOLOMBEK



With the release last month of the Federal Court of Appeal's decision in the General Anti-Avoidance Rule case *Lipson, et al. v The Queen* (2007 FCA 113), a common strategy often recommended

by advisors, and sometimes known as the "Singleton shuffle", may be a lot harder to implement.

The Singleton shuffle, a tax manoeuvre named after Vancouver lawyer John Singleton's 2001 Supreme Court of Canada victory, affirmed the long-understood proposition that if you've got equity, either in your business or in your home, you can borrow against that equity for the purpose of earning income and write off your interest.

Singleton wanted to buy a home using the equity built up in the law firm where he was a partner. Instead of going to the bank to borrow the money, the interest on which would not be tax deductible, he withdrew money he needed from the capital account of his law firm. He then borrowed money from the bank as a "business loan" and used that money to replenish the equity account in his law practice. Since the funds were borrowed directly for the purpose of earning income from a business, the interest on the loan was found by the SCC to be tax deductible.

Since 2001, many Canadians who have mortgages on their homes and who also have nonregistered investments have been encouraged by their advisors and tax

planners to liquidate their non-registered investments and use the proceeds to pay off their mortgage. The investor could then obtain an investment loan secured by the newly replenished equity in their home and use the loan proceeds for the purposes of earning income, thus making the interest on the loan fully tax deductible.

The current case involved a couple, Earl and Jordanna Lipson. Jordanna borrowed \$562,500 from the bank and used the money to buy shares in the family's corporation from her husband Earl. Earl then used the \$562,500 to buy the home. The question before the court was whether the interest expense on the money Jordanna borrowed was tax deductible.

The GAAR, an overarching rule in the Income Tax Act that can attack an otherwise legitimate tax plan for being a "misuse or abuse" of the act, was not argued by the Canada Revenue Agency in Singleton. But the CRA did use the GAAR in the Lipson case. The CRA won in Tax Court last year and won again last month upon appeal. What's most curious about the Federal Court's decision is that even though it agreed with each step of the Lipsons' transactions, including finding that the interest was tax deductible since the proceeds were indeed used for an income-earning purpose, nevertheless, the entire "series" of transactions was found to be abusive when viewed as a whole.

This is clearly a troubling finding as it basically precludes an individual from rearranging his or her affairs in the most tax-effective manner possible.

Let's take the example of Ed, who has a \$300,000 mortgage remaining on his home but also has \$300,000 invested in a variety

of equity mutual funds. Ed is concerned about the future potential of his investments, having risen sharply in 2006, and is fearful that the markets are headed for a downturn.

As a result, he redeems his mutual funds and decides that the best use of the money is to pay off his outstanding \$300,000 mortgage. Six years later, Ed decides that the time is now ripe to reinvest. He walks into the bank, obtains a secured line of credit, collateralized by his now fully paid-off home and uses the proceeds to buy mutual funds.

Given these facts, it would be hard to argue that this "series" of transactions was abusive and that his interest on the investment loan would not be tax deductible. But what if instead of waiting six years to reinvest, Ed waited six months? Or six weeks? Or six minutes?

Shouldn't investors be permitted to structure their affairs in the most tax effective manner possible, as both Singleton and the Lipsons did?

At the time of writing it was Lipson's intention to seek leave to appeal this decision to the SCC, but such right of appeal is not automatically granted. We can only hope that the SCC will grant leave in this case as this is clearly a matter of national importance to all Canadian investors. **AER**

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