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Tax Alert

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New Supreme Court Ruling on GAAR - The Lipson Case

The Supreme Court of Canada released its long-awaited decision in ***Jordan B. Lipson, Earl Lipson v. The Queen*** on January 8, 2009. A majority of the Court (four of the seven judges who heard the appeal) held that the general anti-avoidance rule (GAAR) in section 245 of the *Income Tax Act* (the Act) applied to deny an interest deduction on a loan that was used, indirectly, to fund the purchase of a home. The decision upheld the result in the two courts below. Two separate dissenting judgments were delivered.

The majority's ruling on the applicability of GAAR is quite narrowly focused on the particular facts in issue and on the taxpayers' reliance on the "attribution rules" in the Act. The decision does not appear to change significantly the basic framework for the analysis of when GAAR applies, as established by the Supreme Court in its 2005 decisions in ***Canada Trustco*** and ***Kaulius***. Nor should the decision be taken to establish broader principles that would have major implications for tax planning not involving the use of the attribution rules.

Facts

Mr. Lipson and his wife had agreed to buy a house from an arm's length vendor. The day before the purchase closed, Mrs. Lipson borrowed approximately $560,000 from a bank (the first loan) and used these funds to buy shares of a private family investment corporation (LipsonCo) from her husband. Mr. Lipson then used the $560,000 proceeds to complete the purchase of the home. Title was registered jointly.

The following day, another loan (the second loan) for $560,000 was obtained from the same bank, secured by a mortgage on the house. The proceeds of the second loan were used to repay the first loan.

LipsonCo paid dividends to Mrs. Lipson for each of the three years that were reassessed. In two of those years, the interest expense on the second loan exceeded the dividends received by Mrs. Lipson, resulting in a loss. In one year, the dividends exceeded the interest expense, resulting in net income.

Mr. Lipson's Position

Mr. and Mrs. Lipson filed their tax returns on the basis that the second loan was deemed by subsection 20(3) to have been used for the same purpose as the first loan (i.e. to purchase an income-earning property (the LipsonCo shares)). Accordingly, the interest expense on the second loan was deductible by Mrs. Lipson pursuant to subparagraph 20(1)(c). They also took the position that, because Mr. Lipson had not elected out of the automatic rollover under subsection 73(1), Mrs. Lipson's net income or losses from the transferred shares were attributed to Mr. Lipson under the attribution rules.

Mr. Lipson admitted that there had been a "tax benefit" and an "avoidance transaction," but argued that GAAR could not apply because the transaction did not result in a misuse of the provisions of the Act or in an abuse having regard to the provisions of the Act read as a whole.

The CRA's Position

The CRA reassessed on the ground that GAAR applied to deny the interest deduction to Mrs. Lipson. The result was that Mrs. Lipson's gross income (i.e. the dividends) was attributed to Mr. Lipson, rather than her net income or loss (i.e. after deducting the interest expense).

The CRA did not attempt to apply subsection 74.5(11), an anti-avoidance provision within the attribution rules. It provides that the attribution rules do not apply when it may reasonably be concluded that one of the main reasons for a property transfer that is otherwise subject to the attribution rules is to reduce the amount of tax that would be payable on the income and gains derived from the property. If the CRA had applied this provision instead of GAAR, the interest expense would have been deductible against the dividend income received – but in Mrs. Lipson's hands, rather than Mr. Lipson's.

The result of the reassessments, therefore, was that neither Mr. Lipson nor Mrs. Lipson could deduct the interest expense. The CRA asserted that GAAR should apply because the purpose of the series of

transactions was to borrow money to purchase the house, not to acquire the shares.

Lower Court Decisions

The Minister of National Revenue was successful in both the Tax Court (2006 DTC 2687) and the Federal Court of Appeal (2007 DTC 5172). The Tax Court decision held that the series of transactions resulted in a misuse of all the provisions relied on, because they were carried out for the purpose of making interest deductible on borrowed money used to buy a residence. The Federal Court of Appeal upheld this decision.

The Supreme Court of Canada Decision

The majority of the Supreme Court held that to allow the attribution rules to operate to reduce Mr. Lipson's income by allowing him the benefit of the interest deduction would be an abuse of those rules and that GAAR should therefore apply. The decision characterizes the attribution rules as, themselves, anti-avoidance rules, which were being used to facilitate abusive tax avoidance.

Curiously, although the Minister had approached the assessment by disallowing the interest deduction altogether, and simply adding the gross dividends on the LipsonCo shares held by Mrs. Lipson to Mr. Lipson's income, the Supreme Court ruled that, even though the dividends should continue to be attributed to Mr. Lipson, the interest deduction should be allowed to Mrs. Lipson. The Minister's failure to convince the majority to deny the interest deduction to both Mr. and Mrs. Lipson can therefore be considered a significant loss on a central part of the Minister's case.

Upholding the assessment of the dividends in the hands of Mr. Lipson but indicating that Mrs. Lipson should be allowed the interest deduction seems to be inconsistent with the conclusion that GAAR should apply because the attribution rules had been misused. With all due respect, if the attribution rules were frustrated if they operated to attribute the interest expense to Mr. Lipson, then a more consistent re-characterization of the tax consequences would have been to leave both the dividends and the interest in the hands of Mrs. Lipson.

This result could have been achieved by invoking the specific anti-avoidance rule contained within the attribution rules, subsection 74.5(11). However, the Minister had not based the reassessment on this provision and both parties had agreed for purposes of the appeal that its application was not in issue.

In his dissenting judgment in ***Lipson***, Binnie J. (Deschamps J. concurring) concluded that the Lipson planning should not be found to be abusive tax avoidance. He could not reconcile the majority's conclusion that the interest deduction per se was not abusive, with its conclusion that the plan became abusive with the addition of a spousal rollover that operated precisely as Parliament intended.

The second dissenting opinion was delivered by Rothstein J., who agreed with the reasoning of the majority and of Binnie J. that GAAR did not apply with respect to the use of paragraph 20(1)(c) and subsection 20(3). However, Justice Rothstein's conclusion that GAAR did not apply in respect of the use of the attribution rules was based on his view that the plan should have been found to fail because of the specific anti-avoidance rule contained in subsection 74.5(11). Justice Rothstein noted that if the Minister had applied this rule, the result would have been different because both the dividends and the interest would have remained with Mrs. Lipson rather than being attributed to Mr. Lipson. In Justice Rothstein's view, the Minister should only resort to GAAR when there is no other recourse. In this case, the proper recourse should have been to subsection 74.5(11). This view was rejected by the other members of the Court.

Implications?

It is difficult to state what has been added to the jurisprudence on GAAR by this decision, not least because of the division in the Court and the unusual number of opinions.

It does not appear that the ***Lipson*** decision justifies any change in the CRA's previously established positions. The majority reasons in ***Lipson*** make it clear that the narrow focus of the analysis, and the reason for concluding that GAAR applied, was the introduction of the attribution rules into the planning. Both dissenting judgments are emphatic that planning to finance personal assets out of equity and income earning assets out of borrowed funds is acceptable tax planning. Nothing in the majority decision contradicts this view.

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This article summarizes key points raised in the Supreme Court ruling. The full article is available online at www.collinsbarrow.com/news.asp

SR&ED Incentive Program: "Simplification" of the Claim Form

On November 10, 2008, the Canada Revenue Agency ("CRA") released a new Form T661 and Guide to Form T661 reflecting changes to the scientific research and experimental development ("SR&ED") tax credit filing requirements. The new filing requirements represent one of the biggest changes to the SR&ED program since the introduction of the reporting deadline. Form T661 can be used immediately and is mandatory for taxation years ending after December 31, 2008, making the claims process simpler for some claimants and more complex for others. These changes are relevant for both tax professionals and technical personnel involved in the preparation of the claims.

Background

The purpose of the revised form is to simplify the SR&ED claiming process by having companies disclose more information about their projects when filing a claim. This additional disclosure can help the CRA's automated risk evaluation system to ascertain which claims require more detailed review. As a result, the information provided on the new form will determine the length of time it takes for claims to be processed and which files will require additional attention.

Consequently, the changes to the filing requirements will result in a more difficult and lengthy claim preparation process for *some* claimants, including those whose claims involve more than twenty SR&ED projects, large projects that span a number of years, processes and/or projects involving shop-floor SR&ED, or projects to improve existing products.

Companies that will be in a beneficial position to deal with the program changes are those that have spent ample time and effort to differentiate the technical issues from the business risk issues in their SR&ED projects, and to employ a process of recognizing eligible costs by project. In addition, companies would do well to collect and assemble appropriate supporting material at the time of filing their claims. Support documentation shows the connection between eligible work and costs claimed. Gathering and compiling all relevant project information at the time of filing will ensure the claims will be ready immediately for review by the CRA audit staff and, consequently, will facilitate well-timed responses to subsequent CRA requests for supplementary information.

Companies may face complex CRA reviews if they do not have clear procedures in place to manage their SR&ED claims preparation or adequate documentation to support the projects and costs claimed. Claimants will find it advantageous to begin claim preparation well in advance of the filing deadline so as to comply with the new filing requirements. Companies that do not have a clear procedure for identifying SR&ED and associated eligible costs early might find themselves scrambling to assemble the required information to file a complete claim before the filing deadline. The importance of such a process to facilitate the timely gathering of relevant information for SR&ED claims cannot be over-emphasized.

Major changes to Form T661

- All claimed SR&ED projects must be described, and must now be declared as either pure or applied research, or experimental development.
- The questions regarding the scientific or technological nature of the projects now differ depending on whether scientific research or experimental development was performed.
- For each project, one specific field of science from a defined list must be identified that most closely reflects the nature of the work undertaken.
- Claimants must identify where the work occurred for each project (i.e. laboratory, R&D centre, commercial production facility).
- Claimants must abide by strict word limits with no opportunity to insert graphics (350 words to explain the technological advancement or scientific knowledge sought, 350 words to explain the obstacles to overcome, and 700 words to summarize the work performed).
- All information, including answers to the questions about the technical nature of the projects, must be input directly into the electronic form, as the separate SR&ED project description no longer exists.
- A claimant must disclose the person(s) who assisted the claimant in completing Form T661 and, for each project, the person(s) who prepared the description of the project, together with the name, position, title, and experience or qualification of three key people involved in each project.
- The claimant must disclose whether the SR&ED work was performed on behalf of another party. If other companies or partnerships are involved in the SR&ED claim, their SINs or BNs must be included.
- Claimants must select from a list the types of evidence that are available to support each project.

How do the changes affect SR&ED claimants?

The claimant must describe clearly and concisely the science or technology that was the foundation of the SR&ED project, particularly in light of the new word limitations that have been imposed. Larger business objectives/initiatives should be omitted from the claim.

The word limits will make it difficult for companies claiming large projects that include many trials, as there likely will not be sufficient space to provide all of the trial data that was required in the past. Companies that claim shop-floor projects, or that have incremental improvements requiring significant efforts to achieve, will also have a challenge in succinctly explaining how the complex advancement, the variety of technology limitations, and the range of obstacles impeded their progress. Process-based claims will also face the difficulty of explaining in few words the main interactions between the underlying technologies. In fact, these word limitations could actually reduce the overall comprehension of the projects by the CRA, which may lead to greater use of the "30-day letter," in which the CRA formally asks for additional information under a 30-day time constraint.

Scientific and engineering staff should be familiar with how to highlight effectively the scientific or technological aspects of SR&ED within any business project, while avoiding discussion of the business objectives/initiatives.

The CRA uses the information provided in Form T661 to determine which claims can reasonably be processed as filed, and which claims require further review. The CRA has announced that it is hiring more reviewers, possibly providing it with the capacity to conduct audits more frequently or to spend more time reviewing the more specific claims that are now required.

It is now more important than ever that claimants maintain well-organized claim preparation procedures to ensure that claims meet the new criteria and properly describe the activities claimed. The scientific or technological clarity and conciseness of the information provided will be essential in determining how quickly a claim will be processed and how much time and effort will be required to support the claim during the review.

Contact your Collins Barrow advisor for help in dealing with your SR&ED claims. Our SR&ED team has developed processes to identify qualifying projects, gather the relevant costs and technical documentation required, and expedite the CRA's review, audit and assessment of your claim.

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Fifth Protocol to Canada-US Tax Treaty Ratified

The Canadian Department of Finance and U.S. Department of Treasury have announced that the Fifth Protocol to the Canada-U.S. Tax Treaty ("Treaty") came into force on December 15, 2008. The Protocol contains many new measures significantly impacting Canadian-U.S. cross-border transactions.

The new measures include:

- the extension of Treaty benefits to fiscally transparent entities, such as U.S. limited liability companies, effective for taxation years commencing after 2008;
- the restriction of benefits to certain hybrid entities such as Canadian unlimited liability corporations, effective January 1, 2010; and
- an extended definition of "permanent establishment," also effective January 1, 2010.

There are also measures addressing the resolution of cross-border income tax disputes between the Canada Revenue Agency and the Internal Revenue Service, as well as a limitation of benefits to "qualifying persons" in order to restrict Treaty shopping.

Perhaps the most anticipated new measure is the elimination of withholding tax on cross-border, non-arm's length interest payments. (Canada has already introduced domestic legislation eliminating withholding tax on interest payments by Canadian residents to arm's length non-residents, regardless of their country of residence, effective January 1, 2008.) Under the provisions of the Protocol, the withholding tax on most cross-border interest payments will be reduced from the current Treaty rate of 10% to 7%, effective January 1, 2008. The tax will then fall to 4% for the 2009 calendar year and will be eliminated entirely for the 2010 and subsequent calendar years. As a result of these changes, both Canadian and U.S. recipients of interest in 2008 will be entitled to obtain a refund for any overpayment.

For more detailed discussions of the Treaty amendments, see the Fall 2007 and Fall 2008 issues of Tax Alert following the release of the Protocol provisions on September 21, 2007 and the approval by the U.S. Senate on September 23, 2008, respectively. Contact your Collins Barrow advisor if you have any questions or would like further information.

Collins Barrow regularly publishes Tax Alert for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada. While Tax Alert suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.