# TAXADVISOR

# 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 non-registered 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 the 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 downtown.

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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# SUMMARY *of* THE 2007 FEDERAL BUDGET TAX CHANGES

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As many pundits noted, Finance Minister Jim Flaherty's second budget had a little for just about everybody. Once again seniors featured prominently in the budget. While tax season for 2006 is already upon us, it's never too late to start tax planning for 2007. Often, by this this time next year advisor's will have forgotten about many of the tax changes. Your clients, for the most part, will almost certainly have forgotten. Here's a cheat sheet for you to refer to throughout the year.

## WORKING INCOME TAX BENEFIT

A refundable tax credit for low-income Canadians. The credit is equal to 20% of earned income in excess of $3,000, to a maximum credit of $1,000 for families. The credit also includes an additional disability supplement for each person eligible for the disability tax credit with at least $1,750 of income. The additional credit is equal to 20% of personal income to a maximum credit of $250.

## RESPS

To make RESPs more flexible the government is proposing to eliminate the $4,000 annual maximum contribution, increase the lifetime maximum to $50,000 from $42,000, increase the amount of annual contribution eligible for the 20% CESG to $2,500 from $2,000 and extend RESP eligibility to part-time studies. Those who put the full lump sum into an RESP, however, will waive their ability to collect on CESGs in future years. To get the $500 annual CESG, Jamie Golombek, a tax expert with AIM Trimark Investments, suggests putting the $50,000 into tax-deferred investments that generate capital gains and transferring $2,500 annually into an RESP.

## LIFETIME CAPITAL GAINS EXEMPTION

In lieu of tax relief on capital gains, the budget proposes to increase the current capital gains exemption. Capital gains realized on the disposition of a qualified farm and fishing property or a qualified small business corporation shares on or after the budget will be eligible for a lifetime exemption of $750,000, a $250,000 increase.

## RETIREMENT INCOME PHASED RETIREMENT

The budget includes a proposal to amend the *Income Tax Act* to allow workers to continue accruing pension benefits for work performed with the same employer after retirement or partial retirement.

The budget proposes increasing the age when taxpayers must convert their RRSP to a RRIF from 69 to 71. This change will be extended to those taxpayers turning 70 and 71 in 2007. As a result, these taxpayers can waive the minimum withdrawal requirement from their existing RRIFs for 2007 and 2008.

To increase the flexibility within RRSPs and RRIFs, the government is allowing taxpayers to include: any debt obligation that has an investment grade rating and that is part of a minimum $25 million issuance and any security (other than futures contracts) that is listed on a designated stock exchange.

## REGISTERED DISABILITY SAVINGS PLAN

The budget includes a plan to introduce a RDSP along with a Canada Disability Savings Grant program and Canada Disability Savings Bond program. The RDSP , which would be structured along the same lines as the RESP, is expected to be available in 2008.

## CHILD TAX CREDIT

A new non-refundable tax credit is planned for each child under 18. The credit will be calculated as $2,000 multiplied by the lowest personal income tax rate for the year, resulting in a maximum credit of $310 per child.

## CHARITABLE GIVING

The budget proposes to extend to private foundation the zero-inclusion rate for income and gains arising from gifts of publicly listed securities, placing gifts to private foundations on the same footing as gifts to public foundations. The budget also provides a special deduction to corporations that donate medicines from their inventory to charities that receive disbursements under a Canadian International Development Agency program.

## OTHER HIGHLIGHTS

- Elementary and secondary school scholarships will be fully tax exempt.
- Spousal and other personal amounts will increase to match the basic personal amount, to $8,929 in 2007.
- The public transit tax credit will be extended to include certain electronic payment cards and weekly passes (when at least four consecutive passes are purchased).
- Long-haul truck drivers will be able to deduct more of the cost of food and beverages. The amount will increase to 80%, up from 50%, over the next five years.
- The mineral exploration tax credit for flow-through share agreements, which was to expire at the end of March, will be extended by one year.
- The income tax threshold for individual tax instalments will increase to $3,000 ($1,800 in Quebec) from $2,000 ($1,200 in Quebec).
- Canadians leaving the country for more than 48 hours, but less than seven days, can bring back $400 in tax-exempt goods, an increase from $200.