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Marmer Penner Inc. Newsletter

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Supreme Court Decision in *Lipson*

It seems that all the tax specialists are talking about the Supreme Court's decision in *Lipson v. the Queen*, a General Anti-Avoidance Rule case related to the deductibility of interest.

Mr. and Mrs. Lipson wanted to purchase a house. Mr. Lipson owned shares of a private corporation. Mrs. Lipson borrowed money from the bank to purchase $562,500 of shares from Mr. Lipson. Mr. Lipson then used that money to purchase the house. What is interesting is that it was Mr. Lipson who deducted the interest on the bank loan and not Mrs. Lipson who actually borrowed the money to purchase his shares. Upon selling the shares to his wife, Mr. Lipson did not elect under subsection 73(1) of the *Income Tax Act* and as a result, the disposition occurred at his cost base. Thus, there was no gain or loss on the disposition. Furthermore, under the rules, Mr. Lipson was required to report any of the dividend income she received on these shares and he was required to deduct the interest on the mortgage loan. The court found that Mr. and Mrs. Lipson "misused" the provisions of the *Income Tax Act* which denied Mrs. Lipson the ability to deduct the interest.

Readers may recall another case with a similar fact situation, *Singleton v. the Queen*, which was decided by the Supreme Court in 2001. In *Singleton*, the taxpayer was a lawyer who caused his practice to borrow about $350,000 in order to pay him a significant draw. The draw was used to purchase a home and the interest was deducted by the practice. The Supreme Court upheld the deductibility of interest in the business in *Singleton*. One of the Supreme Court judges referred to the *Lipson* case as "*Singleton* with a twist". The twist in *Lipson* was that the taxpayers tried to use the attribution rules in their favour to make the interest on Mrs. Lipson's bank debt deductible only to Mr. Lipson.

As a result of the *Lipson* decision, taxpayers and their advisors can rest assured that the *Singleton* manoeuvre is still permitted. Furthermore, it is still permitted for a taxpayer to intentionally incur debt where it will be most beneficial from a tax standpoint. For example, if Mr. Smith had a $2,000,000 portfolio of marketable securities and owed Mrs. Smith a $1,000,000 equalization, he would be unable to deduct the interest if he borrowed $1,000,000 to make the equalization payment to her. The interest would be non-deductible since the loan was not incurred to gain or produce income. However, Mr. Smith could have arranged his affairs slightly differently in order to make interest on a $1,000,000 loan deductible. Mr. Smith could have sold $1,000,000 of his portfolio in order to raise the cash to pay the equalization payment. Any such disposition might create additional income taxes from accrued capital gains. Mr. Smith would then borrow $1,000,000 to repurchase the same marketable securities, if he so wished. Now the $1,000,000 is tied to the purchase of investments and the interest is deductible.

As can be seen, the Lipsons had the right idea but were just a little too smart for themselves. If they had left it at Mrs. Lipson deducting the interest on the loan, they would have succeeded. However, they flew too close to the sun when they sought to allow Mr. Lipson the interest deduction.