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Personal Tax Planning – Spousal Flips and Income-Splitting Loans

The tax world is full of paradoxes. As noted in various releases on the *Lipson* case on interest deductibility,[1] even though Mr. Lipson lost his case in the Supreme Court of Canada, the case actually strengthens taxpayers' ability to plan their affairs to maximize interest deductibility. And in general, I agree. But what about the little guy who wants to make his (or her) mortgage interest deductible? It looks to me that the *Lipson* case creates some difficult issues for a subset of personal tax planning transactions pertaining to interest deductions – specifically a manoeuvre I call a "spousal flip". Basically, this involves a spouse borrowing to buy the transferor-spouse's investment or business asset, which is transferred between the spouses on a rollover basis.

The frequency of these "spousal flips" is underscored by the fact that, since the Supreme Court's landmark GAAR decisions in *Canada Trustco*[2] and *Kaulius*,[3] there have been two tax cases involving GAAR and spousal flips – *Lipson* itself and *Overs*,[4] in which this manoeuvre was used to repay a shareholder loan. Ironically, *Overs* – a Tax Court of Canada decision – went in favour of the taxpayer.

In the general case, the ability to make mortgage interest and the like tax-deductible is potentially available to the extent of the unlevered value of business or investment assts (other than RRSPs, TFSAs, etc.). However, if these assets have accrued capital gains or other tax exposure, the road to mortgage interest deductibility may pass through *Lipson*.[5] Suppose, for example, that the unlevered asset is shares in a family business that have appreciated in value. The transferee-spouse borrows to buy the transferor-spouse's shares, which are transferred on a rollover basis to avoid triggering the tax exposure, and the transferor-spouse uses the money to pay down the mortgage or buy a new home. In this case, the attribution rules dictate that the transferor-spouse pays tax on the income and gains from the transferred asset, and claims the associated interest deductions – in spite of the fact that the transferee-spouse is the one that took out the loan.

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This, of course, is basically the *Lipson* situation.[6] And in *Lipson*, the Supreme Court said that, rather than the structuring your affairs to maximize interest deductibility, it was the turning the attribution rules to your advantage that offends GAAR. So it decreed that, instead of the results I just described, the result of GAAR is that the transferee-spouse must claim the interest deduction.[7]

So what happens if an individual wishes to do a spousal flip after *Lipson*? There are number of alternatives, none of which may seem particularly attractive in some situations:

- **Take the position that *Lipson* applies to the particular situation.** This would involve the transferor-spouse reporting the income and gains from the transferred asset, and the transferee-spouse deducting the interest. Although the result of the *Lipson* case is clear enough, a big issue is whether it is possible to actually file a return on this basis. Technically speaking, at least, I question whether this is possible, because you can't "GAAR yourself" – the CRA must do this.
- **Take the position that *Lipson* does not apply to the particular situation.** Filing in a manner that may be inconsistent with a Supreme Court of Canada decision doesn't seem particularly appetizing.[8] Even so, an alternative may be to take the position that the *Lipson* case can be distinguished in the particular fact situation. (In fact, some of the releases by professional firms on the *Lipson* case have suggested that the decision is "fact specific".[9]) For example, a possible basis for distinction is that the manoeuvre is primarily not tax-motivated because the objective of the transaction is to gain protection from creditors.[10] If this is the case, it is arguable that there is not an "avoidance transaction" for the purposes of GAAR, so that the general anti-avoidance rule would not apply.
- **The "swap exception" applies.** The transaction could be structured so that the so-called "swap exception" from the attribution rules would apply.[11] In this case, the transferee-spouse would pay tax on income or gains from the investment, and deduct the interest. However, the swap rule would necessitate reporting the transfer at fair market value, rather than on a rollover basis, thus potentially giving rise to capital gains or other tax, as if there had actually been a sale at this amount. In any event, structuring the transaction in this manner would mean that the transferee-spouse should claim the interest deductions, because the attribution rules do not apply.
- **Take the position that subsection 74.5(11) applies.** The last alternative is to take the position that, rather than GAAR, another anti-avoidance rule applies – subsection 74.5(11).[12] Subsection 74.5(11) provides that the personal attribution rules do not apply to a transfer or loan of property where it may reasonably be concluded that one of the main reasons for the transfer or loan was to reduce the amount of tax that would be payable on the income and gains from the property.

  Unlike the effect of *Lipson*, in which only the interest deductions were attributed to the transferee-spouse, the effect of subsection 74.5(11) would be that both the income or gain from the transferred asset itself – as well as interest on the indebtedness in question – would be taxable/deductible to the transferee-spouse. But unlike the swap exemption, you still get a rollover on the transfer of the investment or business asset.

  For this approach (as well as where the swap exception applies), the transferee-spouse needs a source of income against which to deduct the interest. One possibility is from the transferred asset itself, e.g., dividends on shares of the family business.[13]

Of course the final alternative is not to do the transaction – unless of course, the transaction has already been done – i.e., prior to the *Lipson* case. If so, the going-forward filing position must be considered, along the lines above. Like I said, it is not possible to "GAAR yourself". As I also said, one possibility is to take the position that subsection 74.5(11) applies; however, this could, of course, prejudice previous filing positions.

Before moving on, because some releases on *Lipson* did not stress this, I thought I would point out another troubling issue stemming from the *Lipson* case: the concept that the use of an avoidance provision to bring a tax advantage may be abusive. This could ultimately lead to a sort of "heads I win, tails you lose" approach on the part of

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the CRA. There a number of anti-avoidance rules which can be advantageous to a taxpayer. For example, in certain circumstances, a deemed capital gain resultant from the application of subsection 55(2) may be helpful: if it is desired that funds be distributed from the corporate level, a capital gain may be preferable to a dividend, even if the latter is tax-free at the corporate level, because a corporate-level capital gain will largely tax-pay the distribution to an individual shareholder. Is this result now in question, even if a corporation is clearly subject to subsection 55(2)?

Income-Splitting Loans

I have seen a number of releases recommending that individuals take advantage of the very low prescribed rate that is currently applicable to income-splitting loans and the like. For the first quarter of 2009, the rate is a mere 2%.

But is it possible that the prescribed rate could drop even further? Although we should wait for the formal announcement,[14] it looks to me that this will be the case.

Regulation 4301 sets the prescribed rate as the "simple arithmetic mean . . . rounded to the next higher whole percentage" of the average equivalent yield of "Government of Canada Treasury Bills that mature approximately three months after their date of issue and that are sold at auctions of the Government of Canada Treasury Bills during the first month of the quarter preceding the particular quarter".

Hmmm . . . auctions of Government of Canada T-Bills . . . that would be shown on the Bank of Canada's Web site, www.bankofcanada.ca. First month of the quarter preceding the particular quarter? For the second quarter of 2009, that would be January. And if I am reading the Bank of Canada Web site correctly, it looks like weekly T-Bill auctions this month are under 1%.

Assuming that the foregoing is correct, a 1% prescribed rate would be the all-time low. Not only that, but assuming that T-Bill rates can't go negative, that is as far down as the prescribed rate could go. A glance at financial institution Web sites reveals that it should be possible to beat the 1% rate handily, e.g., by going into a longer-term GIC. However, I have two pieces of advice: first, make sure that the GIC is not over the CDIC $100,000 insurance limit at maturity. Also, for a longer-term investment, one must contemplate the possibility that if things continue to get worse, and government bailouts keep escalating, the ultimate price to pay could be serious inflation.

– David Louis, J.D., C.A., Minden Gross, Toronto, a member of MERITAS law firms worldwide.

Notes:

[1] 2009 DTC 5015, aff'ing 2007 DTC 172(FCA), aff'ing 2006 DTC 2687 (TCC).

[2] 2005 DTC 5523.

[3] 2005 DTC 5538.

[4] *Michael Overs v. The Queen*, 2006 DTC 2192.

[5] I.e., the application of the case and the issues described below may have to be considered.

[6] Mr. Lipson, the transferor-spouse, used the money to buy a home. The interim financing was replaced by a new loan, secured by a mortgage on the home.

[7] However, the transferor-spouse would presumably continue to report dividends and gains from the transferred shares themselves.

[8] Even if the taxpayer is willing to do this, he or she may have to convince the tax return preparer to do so. See Example 15 of Information Circular 01-1, which indicates that, where a return conflicts with a court case, the third-party civil penalties would not apply "if the accountant had determined, and was able to demonstrate that the fact situation was different". Presumably, another consideration for the preparer is whether there is another way to report the transaction, given that a taxpayer cannot unilaterally apply GAAR.

[9] To me, the essence of the *Lipson* strategy involves the transferee-spouse borrowing to buy a previously unlevered asset, transferred on a rollover basis, so that the transferor-spouse claims the interest deductions. A variation, albeit not as technically strong, may involve the transferee-spouse assuming the transferor-spouse's indebtedness as consideration for the transfer.

[10] Would this stand up to scrutiny? The rationale could be undermined by the fact that, if the transferee-spouse borrows to buy the asset, the transferor-spouse will obtain the proceeds of this borrowing, which could potentially be subject to creditor claims. However, this will depend on the facts: in a carefully-structured plan, the fact that the transferor received consideration for the transfer would be helpful from a creditor-protection standpoint.

[11] See subsection 74.5(1). The attribution rules normally apply when an individual transfers property to a spouse, per subsection 74.1(1) and section 74.2, pursuant to which income or losses from the transferred property, as well as capital gains/losses therefrom will be attributed to the transferor-spouse. On the other hand, subsection 74.5(1) potentially overrides the attribution rules. Per paragraph 74.5(1)(*c*), the override will not apply unless the spouses elect not to have the spousal rollover provisions of subsection 73(1) apply. In addition, per paragraph 74.5(1)(*a*), the override will apply if the transferring spouse receives consideration of at least the fair market value of the property transferred.

[12] This, of course, is the key to Rothstein, J.'s dissent.

[13] The higher the income from the transferred property, the stronger the rationale is for the application of this avoidance rule.

[14] Probably sometime in March.

Recent Technical Interpretations

Transfer of Farm Property to Child – Subsection 73(3)

The CRA was asked whether the taxpayer could, under a proposed sale of farmland, transfer the farmland property to her children under ss. 73(3) and (3.1), and if so whether s. 69(11) may apply to deny the benefit of s. 73(3.1).

The taxpayer's spouse, a full-time farmer, acquired farmland many years ago and used it in the business of farming until his retirement. Upon retirement, the farmer leased the land to third parties. When the farmer died, the farmland passed to the taxpayer, who continued to lease the property to third parties. The number of years that the farmer had farmed the property far exceeded the number of years that it was leased to third parties. The farmland is close to a city and has a high value such that it would not

be economically feasible for someone to purchase the land and run it as a viable farm. An arm's length purchaser is interested in acquiring the property to build a residential subdivision on the land.

Instead of the taxpayer selling the farm directly to the proposed purchaser and triggering a large capital gain, the taxpayer proposed that the transfer take place in two steps: first, the taxpayer would transfer the farmland to her children pursuant to ss. 73(3) and (3.1); second, the children would then sell the farmland to the builder. The purpose is to utilize the children's capital gain exemption under s. 110.6(2).

The CRA stated that s. 73(3) requires, among other things, that the farmland must be in Canada, the farmland must be transferred by the taxpayer to a child who was resident in Canada immediately before the transfer, and the farmland has been used principally in the business of farming in which the taxpayer or the taxpayer's spouse or the children or parents of the taxpayer was actively engaged on a regular and continuous basis. The fact that, in the current situation, the taxpayer's spouse is deceased does not prevent the third condition from being fulfilled. Accordingly, the requirements of s. 73(3) would likely be met and the taxpayer could use s. 73(3.1) to transfer the farmland to her children.

Subsection 69(11) operates to deny a tax-deferred rollover where the taxpayer disposes of property to a recipient for proceeds of disposition that are less than fair market value and it may reasonably be considered that one of the main purposes of the series was to obtain the benefit of any deduction in computing taxable income available to a person who would not be affiliated with the taxpayer where the recipient subsequently disposes of the property (or arrangements for the disposition are made) within three years after the transfer. Under s. 251.1 of the Act, children and their parents are not affiliated. Accordingly, if the children sell the transferred farmland within three years of the transfer, s. 69(11) would apply to deny the benefit of the rollover under s. 73(3.1).

Document No. 2008-0294051I7, November 10, 2008

Determination of CCPC Status

This technical interpretation considered whether a corporation had lost its status as a Canadian-controlled private corporation ("CCPC") either because non-residents or public corporations had *de jure* or *de facto* control over the corporation in a particular taxation year. In *Silicon Graphics Ltd. v. The Queen*, 2002 DTC 7112 (F.C.A.) the Court held that in determining control of the corporation under s. 125(7)(*a*), it is necessary to review both the corporation's share register and its constating documents to determine whether disqualifying shareholders had the legal ability to control the corporation's affairs and fortunes. If a person has a right to acquire shares of the corporation that person will be deemed to be in the same position in relation to control of that corporation as if the person owned the shares at that time pursuant to s. 251(5)(*b*).

Paragraph 125(7)(*b*) is intended to prevent a widely held corporation, the majority of shares of which are owned by disqualifying shareholders, from qualifying as a CCPC. However, this aggregation rule will not apply where *de jure* control can otherwise be established. The CRA stated that, in its view, in *Sedona Networks Corp. v. The Queen*, 2007 DTC 5359 (F.C.A.), the Court had already concluded that the corporation would be controlled by a hypothetical shareholder referred to in s. 127(5)(*b*) when it went on to determine the impact of the options granted to non-residents and public corporations. As such, the CRA considered the Court's findings regarding the application of s. 251(1)(*b*) to options issued by the corporation as *obiter dicta* and not binding legal precedent. Although the Court implied that s. 251(5)(*b*) must be applied simultaneously considering the rights held by all persons, the CRA stated that in its view, the Court did not explicitly reject the CRA's reliance on a selective application of that provision to challenge avoidance schemes intended to circumvent the statutory limitations that apply to the CCPC definition.

The CRA prefers a "selective application of s. 251(5)(*b*) on the basis of textual, contextual and purpose interpretation of that provision". Referring to the textual interpretation, the wording of s. 251(5)(*b*) does not specify whether it should be applied simultaneously or separately from the CCPC definition. Referring to the contextual and purposive analysis, Rulings stated that "it appears reasonably clear that s. 251(5)(*b*) was intended to prevent taxpayers from relying upon the issuance of various rights to its shareholders to avoid compromising its CCPC status where a disqualifying person such as a public corporation has the ability to legally control the conduct of its business affairs. Despite the apparent uncertainty following the decision in *Sedona Networks*, the CRA's position is that it is entitled to apply s. 251(5)(*b*) selectively to disregard the rights and options issued to shareholders in order to circumvent the restrictions embodied in the CCPC definition".

A selective application of s. 251(5)(*b*) would be appropriate, for example, where "the terms of the rights and options issued are such that it is reasonable to assume they would never be exercised, or alternatively, where the controlling shareholder, members of the board of directors or corporate officers of a disqualifying corporation have the ability to influence, directly or indirectly, the recipient of such rights and options". It is only necessary to apply that paragraph where it appears that the purpose of the rights and options was to circumvent the statutory limitations on the CCPC definition.

Where there is a unanimous shareholders agreement ("USA"), such agreement is considered relevant for purposes of determining control as it is a constating document of the corporation. *Duha Printers (Western) Ltd. v. The Queen*, 98 DTC 6334 (S.C.C.) provides that the USA

must be examined to determine whether *de jure* control has been removed from the directors to the extent that the existing majority voting shareholder no longer has effective control, in a way analogous to whether the majority shareholder still has the power to elect the majority of the board of directors.

Where disqualifying shareholders do not have *de jure* control, it is relevant to look at whether disqualifying shareholders have *de facto* control. The narrower interpretation of *de facto* control was expressed in *Silicon Graphics* where "the determining factor was the ability of a given party to influence the composition of the Board of Directors, or the way the Board members exercise their powers". The broader interpretation was enunciated in *Mimetix International Inc. v. The Queen*, 2001 DTC 1026 (T.C.C.) where the determining factor was operational control of a corporation. The CRA has confirmed that it supports the broader interpretation and that the factors listed in Interpretation Bulletin IT-64R4 remain valid to determine whether *de facto* control exists for the purposes of the Act.

Document No. 2007-025359117, March 18, 2008

Taxable Benefits: Long-Term Disability and Life Insurance

The CRA was asked about the tax treatment of benefits received by an employee in respect of a long-term disability insurance policy (also known as a wage-loss replacement plan) and a life insurance policy. Although in general, benefits received in the course of employment are taxable under s. 6(1)(*a*), s. 6(1)(*a*)(i) provides an exception for benefits derived from an employer's contributions to a "group sickness and accident insurance plan". This exception would apply to a sickness or accident insurance plan, a disability insurance plan, or an income maintenance insurance plan, as long as the particular plan is a group plan. Contributions made by an employer on behalf of an employee pursuant to one of these plans would not be taxable to the employee pursuant to s. 6(1)(*a*). Benefits paid to an employee from group wage loss replacement plans are included in income pursuant to s. 6(1)(*f*), but the amount included in income is reduced by the total amount of any contributions made by the employee. Therefore, if the employee paid all of the premiums under the plan, any benefit received under the plan would be non-taxable. In addition, if the plan was not a group plan, and the employer paid the premium on behalf of the employee, the payment would be a taxable benefit under s. 6(1)(*a*), but s. 6(1)(*f*) would not apply to any benefits received.

Section 6(4) requires an employee whose life is insured by his or her employer under a "group term life insurance policy" to include a prescribed benefit in income. If the life insurance policy is not a group life insurance policy, any premiums paid by an employer would be required to be included in the employee's income pursuant to s. 6(1)(*a*). The proceeds received by the beneficiary under a life insurance policy after the insured's death are not taxable, regardless of whether the premiums were paid by the employer or the employee.

Document No. 2008-0278501E5, October 17, 2008

Splitting Pension Income in Case of Death

The CRA was asked whether, in the case of the death of a spouse, the other spouse would have the right to split the eligible pension income that he or she receives in a taxation year with the deceased pursuant to section 60.03 of the *Income Tax Act*.

In order to split eligible pension income, section 60.03 requires that

- The surviving spouse be a "pensioner" under subsection 60.03(1);
- The deceased spouse is a "pension transferee" under subsection 60.03(1); and
- The surviving spouse and the legal representative of the deceased spouse must complete and sign Form T1032.

The split-pension income amount will be the amount elected not exceeding 50% of the eligible pension income of the pensioner multiplied by the proportion that the number of months at any time during which the pensioner was married to or was in a common-law partnership with the pension transferee is of 12. In other words, where the pension transferee dies during the month of February, the number of months at any time during which the pensioner was married to, or was in a common-law partnership, would be two and the maximum split-pension amount would be $^{2}/_{12}$ of 50% of the eligible pension amount.

Document No. 2008-0275731E5, September 17, 2008

Deemed Resident Trusts

The CRA was asked whether a testamentary trust, created by the will of a resident in Canada for the benefit of a resident of Canada with a non-resident trustee, will be resident in Canada.

The CRA stated that, generally, a trust is considered to reside where the trustee or other legal representative who manages or controls the trust would be considered resident. Under paragraph 94(1)(*c*), a trust may be deemed resident in Canada where

- The amount of income or capital of the trust to be distributed to any beneficiary depends on the exercise or failure to exercise discretion by any person, including the trustee;

- The trust has a beneficiary who is resident in Canada; and
- The trust has received property from, among others, a person related to the beneficiary and the person who contributed the property has been resident in Canada for a total of more than 60 months during his or her lifetime and was resident in Canada at any time during the 18 months prior to the transfer of the property prior to his or her death.

Paragraph 94(1)(*c*) does not apply if the discretionary power relates only to the timing of the payment, rather than the amount of income or capital that is to be distributed.

Where the first criterion noted above is not met, but the second and third criteria are met, paragraph 94(1)(*d*) requires any Canadian beneficiary with 10 per cent or more of the total fair market value of all beneficial interests in the non-resident trust to include an amount in his or her income of a portion of the trust's foreign property accrual income. Additionally, section 94.1 may apply to require any beneficiaries resident in Canada to include an income amount in respect of his or her interest in the trust annually.

Additionally, under proposed subsection 94(3), a trust that would otherwise not be resident in Canada would be deemed resident in Canada for the purposes elucidated in proposed subsection 94(3) if the trust has either a "resident contributor" or a "resident beneficiary" as those terms are defined in the proposed legislation.

Document No. 2008-0285961E5, September 16, 2008

Trust Residence – Safekeeping Role of a Financial Institution

The situation the CRA was asked to review involved non-resident individuals who had entrusted property in the form of precious metals and company shares to a Canadian financial institution. The financial institution was then advised that its role in respect of the property would be limited to safekeeping. Ten years later, said non-resident individuals were deceased, leaving all the property to their non-resident heirs and legatees. The financial institution did not receive any instructions from the original owners or subsequent heirs or legatees regarding the management of the property. The management of the property by the financial institution was therefore very passive. The CRA was asked if the financial institution was a legal representative with control of the trust or estate property for the purpose of determining if the safekeeping arrangement constituted an estate. The CRA was also asked if the estate could be considered a resident of Canada by reason of the role played by the financial institution. The CRA confirmed that the definition of "trust " in s. 104(1) of the Act was not helpful in determining if an entity could be viewed as a trust for tax purposes. One must rely on civil or customary law to determine if an arrangement constitutes a trust or an estate. Because the executor or liquidator of the estate is normally the legal representative with control of the estate property, the only question is to determine if the financial institution could be viewed as a legal representative with control of the property left in safekeeping. It is the view of the CRA that the financial institution was not a legal representative with control of the trust property by virtue of its sole safekeeping responsibilities in respect of that property. The CRA's opinion was based on the definition of "legal representative" in s. 248(1) of the Act. The residence of the estate would normally be based on the residence of the legal representative who would manage the estate or control the estate property, as explained in paragraphs 1 to 3 of IT-447.

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