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COMMENT

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A COURT DECISION WITH FAR-REACHING IMPACT

The Federal Court of Appeal has upheld the Tax Court of Canada's decision in the Lipson case. The taxpayer was denied the deduction of interest expense related to a mortgage on his home that was incurred to buy income-producing property. This is an important decision that adds more uncertainty to the situation where a taxpayer borrows to invest.

In simple terms, Lipson is a "general anti-avoidance rule" (GAAR) case that involved restructuring a taxpayer's affairs to achieve interest deductibility. The facts of the case are as follows:

- Mr. and Mrs. Lipson had an agreement to purchase their next home and the closing date was September 1, 1994;
- on August 31, 1994, Mrs. Lipson borrowed $562,500 from the bank and used the funds to purchase, at fair market value, 20.83 shares of Lipson Family Investments Limited from Mr. Lipson;
- on the same day, Mr. Lipson forwarded $562,500 to their lawyer's trust account and directed that that amount was to be used to purchase their home;
- on September 1, 1994, the Lipson's lawyer paid $562,500 to the vendor of the Lipson's new home and the home was registered in joint title;
- on the same day, the bank advanced $562,500 to the Lipson's lawyer as proceeds from a mortgage against the new home. The Lipson's lawyer, as instructed, used the mortgage proceeds to repay Mrs. Lipson's loan from the prior day.

This structure was designed so that the taxpayer's mortgage interest would be tax deductible. However, the Canada Revenue Agency (CRA) reassessed based on the *true economic purpose* of the transaction, which, according to the CRA, was to purchase a home and not income-producing property. The Lipsons appealed to the Tax Court of Canada, which held that GAAR applied to the transaction because it was an avoidance transaction, tax benefits would be realized by the Lipsons and the tax avoidance abused the object and spirit of the provisions of the Income Tax Act.

Having lost their appeal at the Tax Court of Canada, the Lipsons appealed to the Federal Court of Appeal seeking a reversal of the lower court's ruling. As noted above, the Lipsons were not successful at the Federal Court of Appeal, which upheld the lower court's ruling.

In order for GAAR to apply, there must be a tax benefit, an avoidance transaction and abusive tax avoidance. According to the courts, all three elements were present in the Lipsons' structure. The tax benefit of the transaction was the deductibility of the interest expense realized on the mortgage. The avoidance part of the transaction was that the purpose was to make non-deductible interest expense deductible. The abusive part of the transaction was that the overarching objective was mortgage interest deductibility and not the purchase of income-producing property.

The Lipson decision seems to go against the Supreme Court's decision in Singleton. Remember, though, that GAAR was not argued in the Singleton decision at the

Supreme Court level. While the Federal Court of Appeal cannot create precedent that supersedes the Supreme Court, the CRA and the Tax Court of Canada will not be able to ignore the Lispon reasoning in similar cases of restructuring for interest deductibility.

One of the troubling aspects to the Lipson decision is the impact of this decision on other interest deductibility strategies. If a taxpayer properly structures his or her affairs so that borrowed money is invested into income-producing property but at the same time uses cash flow for personal expenditures, could the CRA reassess based on GAAR? Given the significance of the Lipson case, there is much anticipation within the professional community that the Supreme Court of Canada will weigh in on this issue and grant leave to appeal.

Tax planning is a constantly changing landscape. As planners develop new strategies, the courts will outline how such strategies should be taxed. Taxpayers must keep up to date on how various transactions will be taxed, especially when important court cases create uncertainty.

I/R 2121.00

2007 FEDERAL BUDGET

Finance Minister Jim Flaherty tabled his second federal budget on March 19, 2007. The budget was multi-faceted and aimed to restore fiscal balance, provide further tax relief for working families, reduce the debt, invest in Canadians, preserve the environment, improve health care, support Canadian troops and support Canadian farmers.

The following is an overview of some of the items that affect individuals.

RRSPs and Other Registered Plans

The budget proposes to eliminate the concept of *"prescribed stock exchange"* that is used throughout the Income Tax Act to qualify investments. For RRSPs and other registered plans, the new phrase is *"designated stock exchange."* A designated stock exchange will be one of a group of exchanges as designated by the minister of finance.

The budget proposes to expand the categories of investments that qualify for investment by RRSPs and other registered plans. The expansion will include any debt obligation that has an investment grade rating and that is part of at least a $25 million issuance. As well, possible investments will include any security (other than a futures contract) listed on a designated stock exchange.

The budget proposes to increase the RRSP conversion age from age 69 to age 71. Once these budget proposals become law, this change will be effective for 2007, which means that a person aged 69 or 70 could transfer his/her RRIF back into an RRSP and wait until age 71 before starting another RRIF. It also means that 69- and 70-year-olds with earned income or unused RRSP contribution room can make RRSP contributions up until the end of the year in which they reach age 71.

$2,000 Child Tax Credit

The budget proposes to introduce a new non-refundable child tax credit for parents for each child under the age of 18 as at the end of each year. The credit will be calculated with reference to the lowest personal income tax rate, which is 15.5 per cent in 2007. The availability of this credit is not income-tested. Assuming that the provinces match this federal government provision, the new credit could be worth about $310 per child.

Donation of Securities to Private Foundations

The budget proposes to extend the rule that currently provides tax incentives to individuals who transfer publicly listed securities to public foundations. The proposal is that the capital gains inclusion rate will be nil on capital gains realized on a donation of publicly listed securities to a private foundation.

Also in the budget is an anti-avoidance provision of a penalty for "excessive business holdings." An excessive business holding will arise in situations were the combined holdings of the donor and the private foundation could allow the donor to retain influence over the donated company shares.

Registered Education Savings Plans (RESPs)

The budget proposes to eliminate the $4,000 annual contribution limit to an RESP. The budget also proposes to increase the lifetime limit from $42,000 to $50,000, the annual Canada Education Savings Grant ("CESG") from $400 to $500 and the maximum CESG from $800

to $1,000 annually (in the case of unused grant room from a preceding year). However, the lifetime CESG will remain the same at $7,200 per beneficiary.

The above-noted changes introduce a new financial planning strategy: a taxpayer could deposit the lifetime maximum immediately upon the birth of a child and only qualify for one annual CESG of $500. A $50,000 contribution plus a single $500 CESG could grow to $115,747 assuming a five per cent annual growth rate and a 17-year term. In this situation, remember that the contribution pattern qualifies for only one $500 CESG.

An alternative would be to deposit $10,000 immediately and $2,500 for each of the following 16 years. This schedule would attract $500 of CESG with the first $10,000 deposit and $500 annually with each subsequent contribution, up to the $7,200 lifetime limit (reached in year 15). Under this second strategy, the plan would accumulate $97,164 by the end of 17 years. This second strategy is designed to maximize both the overall $50,000 contribution limit and the $7,200 CESG.

The analysis demonstrates that under these two alternatives, there is substantial value in the *"power of compounding"* such that maximizing the CESG may not be as valuable as long-term compound growth. Of course, income earned outside the RESP on the non-contributed funds (assuming that the taxpayer had the full $50,000 available at birth of the child) should also be taken into account in a full analysis. Alternative contribution patterns should be analyzed to determine the contribution strategy that best suits each individual's savings pattern.

In addition to the changes in respect of the deposits into the program, the budget proposes to improve the flexibility associated with taking money out of the plan by allowing more part-time educational programs to qualify for student withdrawals from the RESP.

Registered Disability Savings Plans (RDSPs)

The budget proposes a new program designed, beginning in 2008, to allow individuals who qualify for the disability tax credit (or their parent or legal representative) to save for their future needs. The registered disability savings plan (RDSP) will be somewhat similar to the registered education savings plan (RESP) program in that the government will provide annual grants (Canada Disability Savings Grants – "CDSGs") based on the amount contributed. Taxation will be deferred on any income realized on the savings.

The budget proposes a lifetime maximum contribution amount of $200,000 in respect of the beneficiary, with no annual limit. Contributions can be made into the RDSP up to the end of the year in which the beneficiary turns age 59, with no restrictions on who makes the contributions. Contributions are not deductible and contributors cannot request a refund of contributions.

Contributions into the plan will be eligible for the CDSG. The grant, which is based on the amount of the contribution and the family's net income, is as follows:

- 300 per cent on the first $500 and 200 per cent on the next $1,000, where family income is less than $74,357 (up to an annual maximum RDSP amount of $3,500), and
- 100 per cent on the first $1,000 for family income in excess of $74,357 (up to an annual maximum RDSP of $1,000).

Note that the grant is based on family income. For those under the age of 18, this is "family income" as determined for the purposes of the Child Tax Benefit. Once the beneficiary reaches the age of 18, family income will be the beneficiary's own income and that of his or her spouse or common-law partner. The income thresholds will be indexed to inflation.

The CDSG can be earned up to the end of the year in which the RDSP beneficiary reaches age 49 and is subject to a lifetime limit of $70,000 per RDSP beneficiary.

Families whose net income does not exceed $20,833 will also be eligible for an annual $1,000 Canada Disability Savings Bond ("CDSB"), up to a lifetime limit of $20,000, that will be paid by the government into the RDSP. Families with income between $20,833 and $37,178 will be eligible to receive a reduced CDSB.

Payments from the plan must begin by the end of the year in which the beneficiary reaches age 60 and will be subject to maximum annual limits that are calculated based on the fair market value of the plan's assets and with reference to the beneficiary's life expectancy. Only the RDSP beneficiary or his or her legal representative will be eligible to receive payments out of the plan.

I/R 7401.01

CHOOSING A TRUSTEE

Under trust law, a trustee is the person who controls the property that the settler (or testator, in the case of a will) wants to pass onto the beneficiaries of the trust. Trusteeship is an important role in that the trustee will hold the trust property in his or her own name and will be charged with responsibility for fulfilling the provisions of the trust.

While many trusts are structured with the settlor acting as one of the trustees (quite often one of three named trustees, i.e., not in a sole decision-making position), there are many trusts structured with a third-party trustee. An example of a third-party trustee situation typically occurs when parents leave the residue of their estate to their children and chose to leave the assets in a trust for the children. In such a situation, the parents would name a trustee to manage the assets of the trust on behalf of the children as beneficiaries of the trust.

Another example of a third-party trustee might occur when an elderly individual sets up an alter ego trust for his or her assets so that a trustee is in place when he or she is no longer in a position to manage those assets. In such a situation, the settlor would have to choose a trustee to take over the management of the trust assets when he/she is no longer able.

By definition, a trustee should be someone whom the settlor trusts without hesitation. The trustee will be in charge of the assets of the trust and, while there is a trust document in place and various reporting mechanisms, there is the possibility for fraud. One strategy that could be utilized to minimize the opportunity for fraud would be to appoint more than one trustee. With multiple trustees, the opportunity for one individual to act inappropriately is minimized. However, more management time and effort is generally required. Selecting an odd number of trustees, such as three rather than two, will avoid the situation of a tie vote where trustees may be required to exercise discretion. Another strategy to minimize the opportunity for fraud would be for the settlor to communicate his or her objectives with the beneficiaries. This opens the channel of communication and broadens the scope of people who have knowledge of the circumstances, so lowering opportunities for misunderstandings and inappropriate behaviour.

Some of the powers that should be considered for the trustee would include:

- the power to invest in instruments that are beyond the narrow scope of provincial legislation;
- the power to make income tax elections;
- the power to hold investments settled on the trust that are not within the scope of provincial legislation; and
- the power to make payments on behalf of beneficiaries and designate such payments as a distribution to the beneficiary.

Another important component of the trust document would be the process for the replacement of a trustee. A trust may be in place for a very long time depending on the objectives of the settlor, which means that a trustee may need to retire, leaving a vacancy that needs to be filled.

Trusts are an important planning vehicle but care must be exercised in the choice of trustee and the process for the succession of trustees.

I/R 8001.00

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