Personal Tax Planning – Spousal Flips and Income-Splitting Loans

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*(*This release is based on an article published in Tax Notes # 553, February 2009, CCH Canadian Limited)*

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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. This, of course, is basically the Lipson situation[6]. And in *Lipson,* the Supreme Court said that, rather than structuring your affairs to maximize interest deductibility, it was 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, i.e., 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 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 website 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 website 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 websites 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.

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[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 IC 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 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.