

Making your interest tax-deductible

It has become a common practice for financial planners and tax practitioners to recommend to their clients that they replace non-deductible debt with tax-deductible debt. This practice got a booster shot in 2001 when the Supreme Court of Canada (SCC) ruled in favour of a debt reorganization strategy undertaken by John R. Singleton.

Still, practitioners and investors had to temper their enthusiasm as *Singleton* was not reviewed under the broad-reaching general anti-avoidance rule, or GAAR. This spectre of potential GAAR application has now been put to rest with the recent SCC ruling in *Lipson*.

This *InfoPage* gives a brief overview of the *Singleton* and *Lipson* decisions, summarizing the current judicial approach with respect to interest deductibility.

***Singleton v. Canada* 2001 SCC 61**

John R. Singleton, a partner in a law firm, structured a transaction to make the interest on his mortgage tax-deductible. He did this by withdrawing \$300,000 from his law firm's capital account and using it to purchase a home. He then borrowed \$300,000 from a bank to replenish his capital account. Interest on a mortgage is not tax-deductible. However, the loan to fund a capital account contribution is.

Mr. Singleton originally deducted interest of about \$3,700 and \$27,000 in 1988 and 1989. The Canada Revenue Agency (CRA) reassessed Mr. Singleton, refusing to allow his interest deduction for each of those years. Mr. Singleton appealed to the Tax Court of Canada (TCC).

Tax Court of Canada

The TCC found that all the transactions that Mr. Singleton undertook were related. As a result, the Court determined they should be considered as one transaction – the purchase of the home – for which interest is not tax-deductible. The Court ruled that the money was not borrowed for business purposes as the true purpose of borrowing the money was to buy a home.

Federal Court of Appeal

The Federal Court of Appeal reversed the TCC. The Court stated “the issue was whether the separate transactions undertaken by [Mr. Singleton] should be treated as independent transactions or as one transaction.” The Court held that the transactions should be considered independently. It found that the interest was deductible because the direct use of the funds was to refinance the capital account in the partnership and was therefore a valid business expense. Mr. Singleton was entitled to deduct his interest expense because he could clearly trace the borrowed funds to a business-earning purpose (i.e., the refinancing of his partnership capital account).

Supreme Court of Canada

The SCC sided with the Federal Court of Appeal's reasoning. It stated: “While courts must be sensitive to the economic realities of a transaction and to the general object and spirit of the provision, where the provision at issue is clear and unambiguous, as in this case, its terms must simply be applied In this case, a direct link can be drawn between the borrowed money and an eligible use, so [Singleton] was entitled to deduct from his income the relevant interest payments. The transactions in question are properly viewed independently.”

Ultimately, Mr. Singleton was considered to be borrowing for the purpose of earning business income from the partnership. By doing this he was able to convert non-deductible interest into deductible interest.

Lipson v. Canada 2009 SCC 1

While the *Singleton* decision was happily received by those seeking to deduct interest, the scope of legal review was limited to the specific sections of the *Income Tax Act* (Canada) [the "Act"]. It would be eight years later before the SCC would be able to provide further commentary with respect to potential GAAR application.

Facts at issue

In April 1994, Jordanna Lipson borrowed \$562,500 from a bank, which she then used to purchase some shares of the family investment corporation from her husband Earl. He used that money to buy a new family home, and obtained a mortgage loan of \$562,500 from the bank. The mortgage proceeds were used that same day to retire Jordanna's earlier share finance loan.

By virtue of certain spousal rollover and income attribution sections of the Act, Jordanna then owned the shares, but the dividend income and losses were attributed to Earl. Another section of the Act allowed for the mortgage loan to take on the character of the original share loan, thereby preserving interest deductibility. The attribution section also then cast the interest deduction back to Earl.

Decision from SCC in 2009

The sole issue before the SCC was whether the GAAR applied to the series of transactions. While obtaining interest deductibility was a transaction in the series, the SCC made it clear, with reference to *Singleton*, that deductibility in itself was not in question. Specifically, "the tax benefit of the interest deduction resulting from the refinancing of the shares of the family corporation by Mrs. Lipson is not abusive viewed in isolation, but the ensuing tax benefit of the attribution of Mrs. Lipson's interest deduction to Mr. Lipson is."

It would appear then that the plain vanilla *Singleton* shuffle remains safe. That said, if a plan attempts to bring in other elements, the SCC observed that "the GAAR may introduce a degree of uncertainty into tax planning, but such uncertainty is inherent in all situations in which the law must be applied to unique facts."

Draft legislation on losses (including losses from the deduction of interest)

Note that at the time of writing, interest deductibility on money borrowed to purchase common shares and mutual funds continues to be under review by the federal government. Legislative proposals concerning the deductibility of losses, including losses generated from the deduction of interest, still remain in draft form.

For more information, please see our Tax & Estate InfoPage titled *The Proposed interest deductibility rules*.

Implications for investors

The situation in the *Singleton* case is very similar to the advice many Canadians receive from their financial planners before buying a home. A professional advisor might recommend that an investor liquidate an appropriate amount of nonregistered securities (stocks, bonds, mutual funds, etc.) and use the net cash proceeds to reduce the related mortgage commitment. Then, the client can take out an “investment loan” to acquire new securities or repurchase the securities previously sold.

A carefully executed plan will allow an investor to re-characterize the payments from being non-deductible mortgage interest to tax-deductible investment loan interest.

An immediate repurchase of the previously sold securities could have unexpected tax results.

For more information, please see our Tax & Estate InfoPage titled *Capital loss planning*

For more information about this topic, contact your advisor, call us at 1.800.874.6275 or visit our website at www.invescotrimark.com.

The information provided is general in nature and is provided with the understanding that it may not be relied upon as, nor considered to be, the rendering of tax, legal, accounting or professional advice. Readers should consult with their own accountants and/or lawyers for advice on the specific circumstances before taking any action. Commissions, trailing commissions, management fees and expenses may all be associated with mutual fund investments. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. Please read the simplified prospectus before investing. Copies are available from your advisor or from Invesco Trimark.

* Invesco and all associated trademarks are trademarks of Invesco Holding Company Limited, used under licence. Trimark and all associated trademarks are trademarks of Invesco Trimark Ltd.

© Invesco Trimark Ltd., 2009

TEMITDE(03/09)

