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WHEN ARE LEGAL FEES DEDUCTIBLE?

Legal fees that you pay may be deductible for income tax purposes. Listed below are some of the situations where you can deduct legal fees against other sources of income, thus reducing your federal and provincial tax payable for the year.

Business Expenses

Legal fees of a business you carry on are deductible if they relate to earning income from (or preventing a loss from) the business. However, legal fees that relate to *capital* assets are normally not deductible; they are instead included in your cost base of the capital asset, on which you can claim capital cost allowance (depreciation) if the asset is depreciable property. They will also reduce a future capital gain by being included in the cost.

EXAMPLES

You retain a lawyer to help you buy some machinery for your business. The legal fees are not deductible. Instead, they are included in the capital cost of the machinery, on which you can claim capital cost allowance. Thus, you can effectively deduct the fees over time.

You retain a lawyer to help you buy land on which to build a factory. The legal fees are not deductible. Instead, they are included in the cost of the land. Thus, if you eventually sell the land for a capital gain, they will reduce that gain.

Note that if you have a corporation that runs your business, you might not be able to deduct legal fees associated with the corporation, to the extent you pay them personally. Legally, it is the *corporation* that is carrying on business, not you. From a tax point of view, what you own is shares—a capital asset—and legal fees associated with the shares are not deductible unless they relate to earning income from the shares (dividends). If you pay the lawyer with a personal cheque, you should instead record this as a shareholder loan from you to the company, and an expense of the company. The company can then deduct the expense against its own income (or increase its loss to carry over to other years), and can repay you at any time by paying off the loan you made to it, with no tax cost to you.

Expenses of making representations to government, such as lobbying, are generally deductible even though they may relate to capital assets or goodwill.

Property Expenses

Legal fees relating to property are generally deductible on the same basis as for a business. If the fees relate to income generated by the property (e.g., legal fees incurred to collect unpaid rent), they are deductible. If they relate to the acquisition of capital property (e.g., legal fees incurred to buy a rental condominium), they are not, but instead form part of the cost of the property.

Commission Employees

If you are an employee who sells on commission, and you are permitted to deduct expenses associated with your employment, then you may deduct legal fees as part of those expenses. The fees must be normally incidental to the income-earning activity.

Collecting Salary or Wages

Legal expenses paid to collect (or to establish a right to) employee salary or wages are deductible. The same principle applies as above: the expenses relate to an amount that is taxable as income to you, and so they can be deducted.

Legal expenses paid to protect your job (i.e., to keep yourself from being fired) are generally not deductible, though there are some conflicting decisions from the Tax Court of Canada on this issue.

Collecting Severance Pay or a Wrongful Dismissal Award

Severance or termination pay, and awards for wrongful dismissal, are called "retiring allowances" under the Income Tax Act, and are taxable. Legal expenses paid to collect such amounts are deductible, but only to the extent you have income in the year from the "retiring allowance" that is not transferred to your RRSP (which can be done to a limited extent if you worked for the employer since before 1996). If you do not have income from that source (because you are still trying to resolve the case), you can carry the expenses forward and claim them against such income in a future year for up to 7 years.

> ***EXAMPLE***
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> You were fired from your job in 2009. You spend $3,000 in legal expenses in 2009 and a further $1,000 in 2010. In 2010 you receive a $20,000 settlement from your former employer, which under the Income Tax Act is classed as a "retiring allowance". Your entire $4,000 of legal fees is deductible in 2010 against the $20,000 of income.

Collecting a Pension Benefit

Legal expenses paid to collect benefits from a registered pension plan are deductible against the income from the pension plan, with a 7-year carryforward, on the same basis as for "retiring allowances" discussed immediately above.

Divorce and Support Proceedings

Legal fees paid in divorce proceedings are *not* deductible where they relate to the divorce itself, or to property and custody disputes.

Legal fees *are* deductible if you already have a right to support from your spouse or former spouse, and you incur expenses in enforcing payment. Thus, if you go to a lawyer because your former spouse is late in alimony or spousal support payments, your fees in obtaining such payments are deductible.

Since children have a pre-existing "right" under family law legislation to support, legal costs to obtain an order for *child* support are also deductible. Furthermore, legal costs incurred to obtain spousal support, or to make child support non-taxable, are deductible (CRA *Income Tax Technical News* #24). However, the costs of defending a claim for support are non-deductible.

Fighting the CRA

Amounts paid to prepare, institute or prosecute an income tax objection or appeal are deductible, whether paid to a lawyer, an accountant or any other representative. This includes, for example, filing a Notice of Objection, negotiating with the CRA, and taking an appeal to the Tax Court of Canada. Under the CRA's administrative policy (Interpretation Bulletin IT-99R5), it also includes expenses of dealing with an auditor who is reviewing or auditing your tax return, even if you never actually file a Notice of Objection. Expenses of objections or appeals of foreign income tax are also generally deductible.

The Income Tax Act provision allowing this deduction (paragraph 60(o)) does not limit it to contesting an assessment of your own taxes. Therefore, if you pay legal fees to contest a corporation's income tax assessment — which you might do to protect your shareholding in the corporation, or to protect yourself from being assessed later as a director of the corporation — those fees are deductible. Similarly, if you contribute towards the legal costs of a tax shelter in which you have invested and which is being reassessed, then you can deduct your contribution even if it is another taxpayer who is going forward with the appeal while yours is put on hold awaiting the result.

Expenses of defending against a prosecution for tax evasion have traditionally been considered non-deductible, but based on the case law, they might be deductible as ordinary business expenses if the evasion was related to ongoing business profits. **Penalties and fines** are not deductible (Income Tax Act section 67.6).

Moving Expenses

If you move more than 40 km closer to your new place of employment or business than your old home was (to your new place of employment or business), you can deduct a wide range of "moving expenses", using Form T1M, on your personal income tax return. Included in the allowable deductions are the legal costs associated with buying a new home. As well, if you do buy a new home, your legal fees on the sale of your old home are deductible.

Organ or Bone Marrow Transplant

Where a person needs an organ transplant or bone marrow transplant and finds a suitable donor, the transplant recipient may reimburse the donor for a number of expenses including legal fees. The amount paid qualifies as a medical expense credit for tax purposes. Medical expenses are not deductible against income, but to the extent such expenses exceed a certain threshold, they generate a credit that is worth about 21% of the amount paid (the percentage varies by province).

Adoption Expenses

A credit is available for up to $10,975 (for 2010) of adoption expenses, in the year in which the adoption is finalized. These expenses can include legal fees. The federal credit is 15% of the expenses paid. Some provinces offer a similar provincial credit. Quebec provides a refundable tax credit of 20% of up to $15,000 of qualifying expenses.

Note that when an adoption is arranged by a charity, the tax authorities will normally disallow claims for "donations" to the charity that are, in substance, fees for arranging the adoption.

SIMPLIFIED PROCESS FOR SEPARATED PARENTS TO CLAIM CHILD TAX BENEFITS

As you may know, the Canada Child Tax Benefit (CCTB) is available to parents of children under 18, where the couple's income is low or modest. Although structured as a credit under the Income Tax Act, the CCTB is actually paid out monthly by the government. Some 11 million Canadians receive the CCTB annually, with total payments exceeding $16 billion.

Because the CCTB is based on the couple's income, taxpayers who have separated may qualify for the benefit, since their individual income becomes the test for qualifying for the benefit.

The Canada Revenue Agency announced last year that the application process for the CCTB would be simplified, to make it easier for recipients to confirm their living arrangements and marital status for eligibility purposes.

The CRA recognized that, after a breakdown of the marriage or relationship, it was often difficult to obtain the other spouse's (or common-law partner's) information in support of the benefit recipient's claim. For that reason, the CRA simplified the review process, and benefit recipients can now assess their situation and provide all required documents in one step. With this new process, benefit recipients who worry that the CRA will not receive their former spouse's information may immediately submit **two letters from independent third parties** to show that they live at a residential address different from their former spouse.

GST INPUT TAX CREDITS, HST AND QST

If your business is registered for GST/HST, then you are generally entitled to claim **input tax credits** (ITCs) on your GST/HST return, to recover in full all GST or HST that have been charged to you.

In general, ITCs are available for GST and HST paid on inputs to your business (including capital costs), except to the extent you are making "exempt" supplies, such as health care services, financial services, residential rents or selling used residential property. If your sales are taxable for GST/HST purpose, or a "zero-rated" (such as sales of basic groceries, most medical devices and exports), you can claim full ITCs.

It is important to realize that **ITCs are available for both GST and HST that you pay**, regardless of whether you are collecting GST or HST on your sales. Now that the HST has been extended to Ontario and British Columbia (since July 1, 2010), this will come up more and more.

For example, if you are charging customers or clients in Alberta, in most cases you will be billing 5% GST, not a higher rate of HST. But you might pay HST on goods or services your business purchases in an HST province. If you pay 12% HST on a Vancouver hotel room while on a business trip, you can claim the full 12% back as an ITC on your GST/HST return. The GST and HST are fully integrated in this way.

Similarly, if you are selling goods or services to residents of Ontario, you will in most cases be billing them the 13% HST. If you pay 5% GST on supplies that you buy for your business while in Calgary, you can claim that 5% back as an ITC on your GST/HST return.

However, it is just as important to note that the **Quebec Sales Tax is not integrated with the GST/HST**, even though it is a very similar tax and is administered by Revenu Québec together with the GST in Quebec. If you are not carrying on business in Quebec, so that you are not registered for QST, you cannot recover QST that you pay (it is simply a business expense for income tax purposes). Thus, for example, if you go to Montreal on business and the hotel charges you 5% GST plus 7.875% QST on your hotel bill, you can claim an ITC for the 5% GST but not for the QST. If you claim ITCs for any QST your business is charged, the Canada Revenue Agency will assess you to recover those amounts plus interest, if your business is audited. (Businesses that are registered for the QST will charge QST to Quebec customers, and can claim "input tax refunds", essentially the same as ITCs, but only on their QST return, not on their GST/HST return.)

Note that the other provincial retail sales taxes (Manitoba, Saskatchewan, PEI) are also not integrated with the GST/HST. As with Quebec, if you do not actually carry on business in the province you normally do not need to charge these retail sales taxes, which apply to goods and some services sold by businesses that operate in the province.

Note that the question of **whether you need to charge GST or HST on a particular sale** is quite complex, although in very general terms it usually depends on the location of the customer. For details see CRA Technical Information Bulletin **B-103**, available at cra.gc.ca. The rates of GST/HST that you charge to customers in each province are:

British Columbia	12% HST
Alberta	5% GST
Saskatchewan	5% GST
(there is also a provincial retail sales tax)	
Manitoba	5% GST
(there is also a provincial retail sales tax)	
Ontario	13% HST
Quebec	5% GST
(there is also the Quebec Sales Tax)	
Nova Scotia	15% HST
New Brunswick	13% HST
Prince Edward Island	5% GST
(there is also a provincial retail sales tax)	
Newfoundland & Labrador	13% HST

TFSA TIPS AND TRAPS

Every taxpayer can contribute up to $5,000 to a **Tax-Free Savings Account (TFSA)** for each year since 2009, and income earned on the funds in a TFSA is tax-free. If you have not yet opened a TFSA, your limit is $10,000; if you first open a TFSA in January 2011, your limit will be $15,000.

Each taxpayer has the same limit, so you and your spouse can each contribute $5,000 per year.

TFSA contributions are not deductible for tax purposes, but income earned in the TFSA is tax-free and you can withdraw the funds at any time (subject to any restrictions on your investments — for example, if you have bought a two-year GIC, you might have to wait out the two years before you can access the funds, or pay a penalty to the bank for early withdrawal).

A few TFSA tips and traps to be aware of:

- You can withdraw funds from your TFSA at any time, but you must **wait until the next year to replace those funds**, once you have hit the contribution limit. Otherwise the funds you replace will be subject to a 1% penalty tax *per month*.

  <u>Example:</u> suppose you have already contributed $10,000 by July 2010. In September 2010 you need some cash and withdraw $3,000. If you replace any of that $3,000 by recontributing to the TFSA later in 2010, you will be subject to the penalty tax. You have to wait until January 2011 to replace the $3,000. (Once January 2011 comes, you also have additional contribution room of $5,000 as you do every year.)

- The Income Tax Act provides "attribution rules" to prevent income splitting that can reduce tax. For example, if you give or lend money or property to your spouse, income earned from that money or property is generally "attributed" back to you and taxed in your hands rather than in your spouse's hands. However, **income earned in a TFSA is not subject to the attribution rules** as long as it stays in the TFSA.

  <u>Example:</u> you earn $150,000 per year, and your spouse has no income and no TFSA. If you give your spouse $10,000 and your spouse invests the funds in stocks which pay a 4% dividend, the resulting $400 of income will be taxed in your hands at your high marginal rate. But if you put $10,000 into your spouse's TFSA and the TFSA buys the stocks, the $400 of income is tax-free. (Note however that the attribution rules will start to apply if your spouse takes the funds or stocks out of the TFSA and they continue to generate income.)

AROUND THE COURTS

Separated spouses with joint custody need to agree on who gets credits for kids

The Income Tax Act provides an "equivalent to spouse" personal tax credit worth about $2,200 (including the parallel provincial credit, which varies by province). It is available to a taxpayer who is *not* married and has no common-law partner, but supports another family member who lives with them (typically a young child). As well, there is a "child tax credit" for parents of children under 18, worth about $450 per year. (These are separate from the Canada Child Tax Benefit discussed further above.)

If parents of a child are separated or divorced, the parent with custody of the child is the one who can claim the equivalent-to-spouse credit and the child tax credit. If the parents share joint custody, only one of them can claim these credits,

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and they need to agree as to who gets the claim. Paragraph 118(4)(b) of the Income Tax Act specifically provides that if they "fail to agree", no credit is allowed to either of them.

In the recent *Krashinsky* case, the parents were separated and had joint custody of their son. They could not agree as to who would get the equivalent-to-spouse credit and child tax credit. Mr. Krashinsky claimed these credits, and the CRA assessed him to deny them. He appealed to the Tax Court of Canada.

The Court ruled that the wording of paragraph 118(4)(b) of the Income Tax Act is clear. Since the parents had not agreed as to who could claim the credit, neither of them could claim it.

The judge noted: "This is an issue that should routinely be addressed at the time of the separation agreement, where joint custody is an issue.... the zero sum approach of denying any credit without agreement can create a harsh and unfair result".

Clearly, in such a case, even though the parents may not be getting along, it is in their joint interest to agree that one of them can claim the credits (and presumably agree on an offsetting payment of part of the amount in question by that parent to the other).

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Should you have any questions regarding the foregoing or other tax matters, please contact our tax group at (403) 262-2116.

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