



## Claiming a Deduction for Legal and Accounting Fees



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## CLAIMING A DEDUCTION FOR LEGAL AND ACCOUNTING FEES

The need to spend money on legal or accounting fees is rarely associated with life's happier events or circumstances. Rather, the occasions that come to mind in relation to such expenditures include filing a tax return (or worse, resolving a disagreement with the tax authorities), making a will, getting a divorce, settling support or custody disputes, or making a claim for unpaid wages or pension benefits. However, it is also the case that no one gets through life without encountering at least one of those circumstances. And, as anyone who has had to pay for them knows, competent legal and accounting advice and services aren't inexpensive.



When the need to make such expenditures can't be avoided, the next question which usually comes up is whether a tax deduction can be claimed or a tax credit received in respect of those costs. As is often the case in tax matters, the answer is "maybe".

The bad news is that there is no general right to claim a deduction for legal or accounting expenses incurred and such expenses paid for common life events like buying or selling a home or making a will don't qualify for any such deduction. In fact, a look through the Canadian income tax return form won't even turn up a line on which legal expenses

and/or accounting expenses can be specifically claimed. The reason is that such expenses can be claimed only where they are incurred for very specific reasons or in very specific circumstances. As well, some types of legal fees incurred for some purposes or in some circumstances are deductible by all individual taxpayers, while a claim for other kinds of such expenses are restricted to particular taxpayer groups.

There is good news, however, in that qualifying legal and accounting fees are deductible from income. Being able to claim a deduction (as distinct from a tax credit) means that one's income is effectively reduced by the amount of that deduction and so no tax is payable on that portion of income. A tax credit, on the other hand, reduces tax payable, but the amount of the credit is limited — generally to 15% of the amount of the expenditure for federal purposes. Consequently, for taxpayers who have annual taxable income of more than about \$45,000, the ability to claim a deduction offers a much better tax result than a claim for a tax credit.

All individual taxpayers are entitled to claim a deduction for legal and accounting fees incurred in connection with the following:

- an income tax reassessment or a decision relating to income tax or to the taxpayer's rights in relation to Employment Insurance, the Canada Pension Plan, or the Quebec Pension Plan (but not Old Age Security or the Guaranteed Income Supplement); or
- a claim to collect or establish a right to salary, wages, a retiring allowance, or a pension benefit; or
- claims to establish the amount of support payments receivable, to get an increase in such support payments, to collect late support payments or to make child support payments non-taxable.



## Resolving a dispute with the federal government

Each year, millions of Canadians file an annual tax return, reporting their income, claiming available deductions and credits, and indicating the amount of tax which they must pay for the year. The Canada Revenue Agency (CRA) then reviews the filed return and prepares a Notice of Assessment, which outlines the Agency's conclusions with respect to the same figures. In most instances, that Notice of Assessment will agree with the tax return filed by the taxpayer, perhaps with a few arithmetical corrections. In some cases, however, differences will arise and the taxpayer must decide whether to dispute the CRA's conclusions with respect to his or her tax liability for the year.

There are several steps or stages involved in responding to an Assessment (or Reassessment) issued by the CRA. The first involves communication with the CRA, whether in



writing or at a meeting with representatives of the Agency. Where the differences can't be resolved by such communication, the next step is to file a Notice of Objection, which will require the CRA to review the

original Notice of Assessment (or Reassessment) issued and either confirm its conclusions or issue an amended Notice. Finally, where no agreement can be reached between the taxpayer and the CRA, the taxpayer is entitled to dispute the assessment or reassessment in the courts.

At each step of this process, legal and related accounting fees paid by the taxpayer to respond to the CRA are deductible from income. It's not necessary for the taxpayer to go to court, or even to file a Notice of Objection in order to claim that deduction for legal or accounting fees paid. So, for instance, a taxpayer who disagrees with a Notice of Assessment received and pays for legal or accounting help to draft a response or attend a meeting with CRA representatives can claim a deduction for the cost of such help. And, of course, should the dispute proceed further through the objection and appeal process, legal and accounting fees incurred in relation to that process will similarly be deductible.

There are also a number of government-sponsored social welfare programs for which the determination of both entitlement and quantum of benefits can have a significant impact on the financial wellbeing of the individual. Those programs include Employment Insurance (EI) benefits and the Canada Pension Plan (CPP) and Quebec Pension Plan (QPP).

Where an individual applies for EI benefits, the federal government must determine whether the individual was engaged in insurable employment, whether he or she has met the requisite criteria with respect to the number of hours worked, the amount of any benefits which may be received, and the length of time for which such benefits will be paid. Where that individual who has applied for EI benefits disagrees with decisions made by the federal government with



respect to any of these questions, he or she can deduct legal or accounting fees paid to contest that decision.

While disputes involving an individual's entitlement to Employment Insurance benefits are certainly important to the individual involved, it's also true that the financial impact of decisions made are relatively short-lived. That's not the case where the a government decision is made with respect to an individual's right to Canada Pension Plan or Quebec Pension Plan benefits.

Most benefits paid under those Plans are retirement benefits and, once the right to CPP or QPP benefits is established, those benefits are paid for the remainder of the individual's life. Consequently, the negative financial impact of a denial of such benefits, or a reduction in the amount of benefits to which an individual is entitled, will be a life-long one. Fortunately, where any decision is made under the CPP or the QPP and the individual disputes that decision, he or she can claim a deduction for legal or accounting fees paid in connection with that dispute.

It should be noted that, although the federal government possesses the same authority to determine individual eligibility and quantum of benefits under the Old Age Security and Guaranteed Income Supplement Programs, no deduction is available for legal or accounting fees incurred to dispute a federal government decision made under those programs.

### **Collecting salary, wages, retiring allowances, and pension benefits**

While most employers pay amounts owed to employees when required and in full, there are times when employees have to pursue their rights to such payments through the legal system. And when they do, a deduction may be claimable for related legal fees incurred.

Specifically, the rules provide that a deduction may be claimed for legal fees paid to

collect salary or wages, a retiring allowance or pension benefits. While the terms salary and wages or pension benefits are reasonably self-explanatory, such is not the case when it comes to retiring allowances. In fact, the term "retiring allowance" is in some cases a misnomer, as the amounts in issue do not have to be related to retirement and the employee seeking to collect those amounts doesn't have to be retired or retiring. Rather, for the purpose of claiming a deduction for legal or accounting fees, a retiring allowance includes both amounts received by an individual on or after retirement from employment in recognition of the individual's long service, and amounts received by individuals when their office or employment is terminated (including damages for wrongful dismissal). There is a much longer list of kinds of receipts which do not qualify as a retiring allowance, and that list includes salary, wages, retention bonuses, a superannuation or pension benefit, an amount an individual receives as a result of an employee's death, benefits derived from certain counselling services, and accrued vacation pay.

An employee who incurs legal fees to collect a retiring allowance is generally able to deduct those fees from income in full, up to the amount of the retiring allowance received. There is one exception to that rule: an employee who was employed by his or her employer prior to 1996 can transfer a specified portion of the retiring allowance collected to his or her registered retirement savings plan (RRSP) or registered pension plan (RPP). Where such a transfer is made, the amount of retiring allowance received must, for purposes of calculating the maximum deduction for legal fees, be reduced by the total of amounts transferred. An employee who was employed by the employer prior to 1989 can similarly transfer funds received to an RRSP or RPP, albeit in smaller amounts.

The amount that is eligible for transfer to an RRSP or RPP is generally limited to:



- \$2,000 for each year or part of a year before 1996 that the employee or former employee worked for the employer; plus
- \$1,500 for each year or part of a year before 1989 of that employment.

Finally, where there are legal fees which cannot be claimed in the year they are paid, those fees can be carried forward and claimed in any of the following seven years.

### Obtaining, increasing, or collecting support amounts

When parents separate, reaching agreement on arrangements for custody and support is often the most difficult part of negotiations. And, not infrequently, disagreements around such arrangements, or the ongoing fulfillment of such arrangements, cannot be settled without resort to the courts and, inevitably, the need to pay legal fees.

It's also an unfortunate fact that the rules around the tax treatment of support payments

The first, basic rule is that neither party to a separation and divorce, no matter what the circumstances, can claim a deduction for legal fees incurred to obtain that divorce or to establish child custody or visitation rights.

Where a dispute over the payment of support amounts or the amount or collection of such support amounts require an individual to incur legal fees, it is possible, in some circumstances, for the individual to claim a deduction for such costs. That deduction is available, however, only where the legal fees are incurred by the recipient of support amounts in order to establish, increase, or collect those amounts. Specifically, an individual who is the recipient of support amounts can claim a deduction for legal fees incurred to:

- collect late support payments;
- establish the amount of support payments from their current or former spouse or common-law partner;
- establish the amount of support payments from the legal parent of their child (who is not their current or former spouse or common-law partner) where the support is payable under the terms of a court order; or
- to try to get an increase in support payments.

As well, child support payments made are sometimes taxable to the recipient and sometimes, depending on the circumstances, can be received tax-free. Where a recipient of child support payments goes to court seeking an order that such payments received are tax-free, legal fees incurred to try to get that order are deductible from income.

The situation is quite different for the payer of support amounts, who cannot claim a deduction for legal fees incurred to negotiate, establish, or contest the amount of support payments.

A word of caution is advisable — the rules governing the tax treatment (that is taxable vs. non-taxable) of support are complex and very subtle differences in wording in a separation or support agreement can make all the difference in the tax treatment of such

and those governing the deduction of legal and accounting fees incurred in relation to support payments are undeniably complex. For the majority of those who encounter them, those rules don't always seem consistent or logical.



support payments. Although it may seem that such a document can, once agreement is reached, be drafted by the parties to the agreement, that's not at all advisable. Often, the tax treatment of a support amount payable is factored in to the amount of such payment, and anyone entering into such an agreement is very well-advised to seek professional advice to ensure that the expected and desired tax treatment is in fact realized.

### **Deductions claimed by commission employees**

Employees who work on commission — usually those engaged in sales — occupy the tax territory somewhere in between employee and the self-employed. Often that means that deductions denied to employees are available to be claimed by an individual who earns income from commissions. That more generous tax treatment extends to claims for a deduction for legal and accounting fees.

Although millions of Canadians pay an accountant to prepare their tax returns each year, fees incurred for that service (unlike fees paid to pursue a tax dispute with the CRA) cannot be deducted from income by the majority of taxpayers. That's not the case for commission employees, who can deduct reasonable accounting fees paid for help to prepare and file their annual tax return. And, of course, should the filed tax return lead to a dispute with the CRA over amounts earned or owed, legal or accounting fees incurred to contest that dispute will similarly be deductible from income.

### **When legal fees are reimbursed**

At the end of any legal proceeding, the Court gives its conclusions with respect to the issues before it and its reasons for those conclusions, and provides judgment in

favour of one party or the other. Often the Court will also make an award of "costs" and where such an award is made, one party to the case is required to pay some (very rarely, all) of the legal costs incurred by the other party to initiate or defend that legal action. Where an individual is the beneficiary of such an order, and receives a payment to cover some of the legal costs incurred, any amount claimable as a deduction for those costs must be reduced by the amount of that payment. So, an individual who incurred \$10,000 in deductible legal fees in connection with a dispute but receives \$3,000 from the other party pursuant to a costs award can claim a deduction only for the difference, or \$7,000 in legal fees.

It sometimes happens that reimbursement for legal fees incurred is received in a year after the one in which the deduction for the full amount of legal fees incurred was claimed. In that case, the individual who receives the reimbursement must include that amount in his or her income for the year in which it was received.

### **Conclusion**

It is undeniable that the tax treatment of legal and accounting fees is complex, particularly for those who encounter the need to decipher those rules only once or twice in a lifetime. Where the amount of such legal or accounting fees incurred is substantial (and particularly where such fees are paid in relation to a support dispute), obtaining advice from a professional tax adviser is well-advised. There is also a wealth of information available on the subject on the CRA website, and the starting point for obtaining such information can be found at [www.cra-arc.gc.ca/tx/ndvdl/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns206-236/232/lgl-eng.html](http://www.cra-arc.gc.ca/tx/ndvdl/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns206-236/232/lgl-eng.html).