

Tax Topics

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A QUESTION OF DEDUCTIBILITY: PROFESSIONAL FEES AND LITIGATION DEALING WITH BOTH INCOME AND CAPITAL ITEMS

— Adam Friedlan, *Friedlan Law, Richmond Hill, Ontario*

The recent case of *Richards v. The Queen*, 2020 DTC 1005 (TCC), provides a helpful review of issues relating to the deductibility of professional fees incurred in respect of litigation involving both income and capital related purposes.

The case deals with corporate and family litigation that arose from the breakdown of a marriage. The Appellant was a shareholder of two corporations along with her then husband, Mr. Richards. The first corporation, Jaylynn Enterprises Ltd. ("JEL"), was formed in 1975 (prior to the Appellant's marriage in 1976). The second corporation, Holm Realty ("Holm"), was formed in 1989. Both the Appellant and Mr. Richards worked in the daily operations of the business operated by these corporations. A corporate reorganization was undertaken in 1993 which introduced family trusts as a shareholder. At the time of the separation of the Appellant from Mr. Richards in 2010, the Appellant directly held two classes of preference shares in JEL.

Prior to the separation, both the Appellant and Mr. Richards relied on dividends received on their respective preference shares in JEL for income. Both parties had to consent to the payment of dividends.

After their breakup the Appellant and Mr. Richards had to "untangle" their interests in JEL and Holm. Unfortunately, litigation ensued after Mr. Richards declined to consent to the payment of further dividends, leaving the Appellant with no source of income.

The resulting dispute saw the Appellant pursue two paths of litigation: the first for spousal support and the second a corporate oppression application under applicable Nova Scotia company law. By way of background, an oppression application, generally speaking, is a statutory corporate remedy provided to certain qualifying parties who have been negatively affected by the actions of a corporation.

The Appellant incurred a total of \$73,579.27 of professional fees (the "Professional Fees in Dispute"). \$65,782.22 of the professional fees related to the oppression application and \$7,797.05 related to the spousal support litigation.

The Appellant's motion made as part of the oppression application sought an order relating to the requirement for the consent of the Appellant to transactions undertaken by JEL of more than \$50,000, and stopping Mr. Richards from impeding the Appellant's access to corporate records. An alternative remedy sought as part of the litigation was a direction mandating that JEL and Holm pay dividends on the shares held by the Appellant. In addition, a motion judgment issued as part of the oppression litigation also stated that the Appellant had agreed in cross-examination that the main relief she sought as part of the oppression litigation was the redemption of her shares.

The support litigation determined that the Appellant would receive \$6,000 per month in spousal support. A final agreement reached after the motion relating to the oppression litigation led to, as stated in the Justice's decision, "the Appellant receiving a dividend of \$1,533,469.16 as a result of her transferring 237 preferred shares of JEL to Mr. Richards." A transfer of shares to Mr. Richards would ordinarily result in a capital gain. It is not clear from the judgment why the transfer resulted in a dividend. Perhaps the dividend in fact arose from the Appellant surrendering her 237 preference shares in JEL to JEL itself.

By notice of Reassessment in respect of the Appellant's 2013 taxation year, the Minister of National Revenue (the "Minister") disallowed the deduction of the Professional Fees in Dispute (\$73,579.27) on the basis that they were an expense spent in large part on the oppression application.

It was the position of the Minister that the Professional Fees in Dispute were not deductible by virtue of paragraphs 18(1)(a), (b), or (h) of the *Income Tax Act* (Canada) (the "ITA") in that the fees were either not paid to earn income, were on account of capital, or were an outlay that was personal in nature.

In the appeal from the Minister's decision, the Tax Court held that it was settled law that expenses incurred to obtain spousal support are allowed as a deduction (citing *Nadeau v. R.*, 2003 DTC 5736 (FCA)). The Court also held that expenses incurred to obtain the payment of dividends were also deductible (being expenses laid out to earn income).

The Court accepted that \$3,470.10 of fees paid by the Appellant were directly related to spousal support and therefore deductible. Thus, the question before the Court was the deductibility of the expenses incurred in respect of the oppression application.

The Court reviewed the relevant jurisprudence and in particular the decision of Justice Archambault in *Kruco Inc. v. R.*, 98 DTC 1568 (TCC). *Kruco* concerned in large part the deductibility of legal fees incurred in respect of an oppression case. In the course of his decision, Justice Archambault cited the "enduring benefit test" developed in *British Insulated & Helsby Cables Ltd. v. Atherton* (1925), 10 T.C. 155 (U.K.H.L.), the decision in *Minister of National Revenue v. Algoma Central Railway* (1967), 67 DTC 5091 (Can. Ex. Ct.), and the decision of the Supreme Court of Canada on the appeal of the latter case (68 DTC 5096 (SCC)). The test asks whether the relevant expenditure was made "with a view of bringing into existence an advantage for the enduring benefit of the appellant's business".

The Court held that while it was initially inclined to accept the Minister's contention that the fees laid out in respect of the oppression application were on account of capital, the evidence adduced at trial had shown that there was a nexus between the litigation and the Appellant's pursuit of either spousal support or dividend income. In support of this nexus to an income producing purpose the Court cited, among other things, the fact that prior to the breakup the Appellant had received regular dividends, that the Appellant's spouse stopped these dividends, that the end result of the litigation resulted in an agreement making payable a large dividend to the Appellant, and that an alternative remedy sought in the oppression application was an order directing the payment of dividends.

Nevertheless, while this nexus to an income producing purpose was present, the Court held that the dominant purpose of the professional fees was the protection of the Appellant's rights in her shares in the relevant corporations. Such protection would be the kind of enduring benefit that the aforementioned jurisprudence would regard as capital in nature. In support of this conclusion, among other things, the Court pointed to the fact that the main remedy sought in the oppression application was the redemption of the shares held by the Appellant in the relevant corporations.

Thus, the Court held that a dominant portion of the costs occurred in relation to the oppression litigation was on account of capital and therefore not deductible. However, although the dominant purpose was on account of capital, the Court allowed that some of the fees related to an income earning purpose. Applying a reasonable apportionment, the Court allowed 25% of the professional fees in respect of the oppression litigation to be deducted in the relevant taxation year. Because the issue was not dealt with by the parties at trial, the addition of the capital expenditure to the adjusted cost base of the relevant property was not addressed in the Court's judgment.

It is worth noting that the Court seemed to cite the fact that the Appellant sought the "redemption" of her shares in support of the conclusion that the oppression litigation was on account of capital. Ordinarily, a redemption of shares would result in a deemed dividend in circumstances where the paid-up-capital of the shares was less than the proceeds of disposition (subsection 84(2) of the ITA). In fact, the decision notes that the ultimate result of the litigation resulted in the Appellant receiving "a dividend payment of \$1,533,469.16 as a result of transferring her 237 preference shares to Mr. Richards." A transfer of shares by an individual to another individual would not be a redemption under the relevant corporate and tax law. So, while it is possible that the shares held by the Appellant in JEL and Holm were held on account of capital, it seems likely that the oppression litigation was incurred primarily for the purpose of triggering a

deemed dividend. Therefore, the oppression litigation would be on account of an income item. However, the facts as set out are not sufficiently clear to state this with certainty.

Richards, while it does not break new ground, acts as an important reminder to professionals regarding the tests to determine whether professional fees are deductible as income items or must be capitalized. Many times professional fees have a dual character, in that work has both an income earning purpose and a purpose more clearly identifiable as capital expenditure. As a practical matter it is often difficult to arrive at a reasonable apportionment between income and capital-related work and it is advisable to keep a note on file regarding the potential apportionment as between the two categories should an issue of deductibility subsequently arise.

Adam Friedlan, Friedlan Law, Richmond Hill, Ontario, A.B., University of Chicago, J.D., University of Toronto. Friedlan Law's practice includes corporate and personal tax planning, estate planning, and legal implementation of tax and estate plans.