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Vern Krishna: CRA rules make it tough for employees to deduct professional fees



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Canada's Income Tax Act is one of the country's largest and fastest growing statutes. Vern Krishna asks: Why does the CRA deny employees the right to deduct professional fees for tax advice? Fotolia

CRA rules make it tough for employees to deduct legal fees

Canada's income tax act is one of the country's largest and fastest growing pieces of legislation. So why does the CRA make it so tough for employees to deduct legal expenses, Vern Krishna asks

The Income Tax Act, at 3,000 pages and growing rapidly, is the single most complex and dense statute in Canada. Nearly 15 million employees file income tax returns annually and are the largest source of government revenues.

The law presumes every taxpayer to know the law in all its exacting detail and imposes severe penalties for misinterpretation. However, employees are not allowed to deduct any professional fees that they pay for tax advice and return preparation. The law also deems the Canada Revenue Agency's assessment of a taxpayer to be correct unless the taxpayer can prove otherwise, usually through expensive and protracted litigation. Employees may, however, deduct their legal fees after they get into trouble with the CRA.

The government's policy to deny a deduction for fees spent on prevention of litigation, but to allow it for legal fees after the dispute arises, may be good for revenue collection and tax administration. But it is not fair for taxpayers who must comply with an incomprehensible statute.

Legal fees and expenses are deductible on a cash basis — that is, in the year that the taxpayer pays them. The fees are deductible even if the objection or appeal relates to the taxpayer or some other person in whom the taxpayer has an interest. For example, fees that a director or shareholder pays to contest a corporate assessment may be deductible. Similarly, a tax shelter investor who funds another person's appeal in order to protect his own interest may deduct the legal fees that he or she incurs. The law is uncharacteristically generous here and allows taxpayers to deduct fees and expenses paid to non-lawyers — for example, to accountants, consultants, and even paralegals.

An employee can deduct legal fees to collect salary and wages from her employer or former employer, insurance benefits under a sickness or accident insurance policy that the employer provides, or payments under the Canada Pension Plan. Unlike expenses for objecting to an assessment, which are deductible even if paid to non-lawyers — for example, accountants and consultants — fees to collect salary, wages, insurance and CPP are deductible only if they are legal fees. Hence, fees paid to paralegals and non-lawyers should not be deductible.

The interpretation of what constitutes deductible legal fees is not always easy. In the context of fees paid to collect salary or wages, for example, the jurisprudence is beset with subtle distinctions. In one case, 55 Department of Justice lawyers in Vancouver brought an action for damages against their employer claiming that they were entitled to the higher salaries that the department paid to their counterparts in Toronto — in effect, a legal action for equal pay for equal work. The Federal Court of Appeal allowed the lawyers to deduct their legal fees regardless of the substantive merits of the litigation and the nature of the taxpayers' claim. In another case, however, the court did not allow employees to claim a deduction for legal fees paid to establish a right to a promotion that would entitle them to a higher salary.

The law is similarly subtle in actions against judicial or regulatory decisions that adversely affect employment, professional status, or claims for financial compensation in connection with allegations of unlawful or wrongful acts by the employer. For example, a professor who paid legal fees to protect him against complaints from students — which, if established, would have affected his career and eliminated his income — could not deduct the fees even though he was successful.

The deductibility of legal fees from employment income sometimes depends upon whether the lawsuit is successful. For example, a police officer convicted of dangerous driving could not deduct his legal fees when he was automatically suspended without pay. Upon his successful appeal, however, the officer could deduct his entire legal fees because his suspension changed retroactively to being with pay.

The fine legal distinctions of deductibility of legal fees and expenses for litigation but not for prevention of disputes has less to do with fundamental policies of tax law and fairness and more with the ease of revenue collection and administration.