

Legal Fees: What's Deductible and When?

Very few Canadians escape paying personal legal fees at one time or another, and depending on the situation, those fees can add up quickly. Unfortunately, while legal fees incurred in some circumstances may be deducted from income on the annual tax return, there sometimes doesn't seem to be any rhyme or reason to what's deductible and when.

First, the bad news. Legal fees incurred in situations experienced by millions of Canadians — for example, legal costs paid in connection with the purchase or sale of a house, or legal costs paid to obtain a divorce or to establish custody or visitation rights — are not deductible. Generally, personal (as distinct from business-related) legal fees become deductible for most taxpayers only when they are seeking to recover amounts that they believe are owed to them, particularly where those amounts involve employment or employment-related income or, in some cases, family support obligations.

While the term “legal fees” would seem to be self-explanatory, in fact such amounts don't always have to be paid to a lawyer to qualify as “legal fees” for the purpose of the deduction. For example, an employee whose employment is terminated could deduct amounts paid to a consultant in labour relations to negotiate a severance package on his or her behalf.

Perhaps the most common situation in which legal fees paid become deductible is that of an employee seeking to collect (or to establish a right to) salary or wages. This might involve an employee who, having been “downsized” out of a job, brings legal action alleging that the amount of notice (or compensation provided in lieu of notice) was insufficient. In that situation, legal fees incurred to establish a right to amounts allegedly owed by the employer are deductible by the former employee.

While legal fees incurred in order to establish a right to such income are deductible, there are limits on the amount of the deduction. In effect, the deduction claimed for the year for legal fees can't be more than the amount received in the year to which the legal fees incurred relate.

The rules governing the deductibility of legal fees paid in connection with the enforcement of support obligations are, unfortunately, more complex, much like the tax rules governing the taxation of support obligations generally. Nonetheless, there are some general guidelines that can be laid out.

First of all, as noted above, legal costs incurred to obtain a separation agreement or a divorce, or to establish custody or visitation rights, are not deductible under any circumstances. And at one time, the Canada Revenue Agency took the position that such costs incurred in connection with spousal or child support obligations were similarly not deductible. In recent years, however, the Agency has relaxed its position somewhat, and legal fees paid for the following purposes will be deductible by the person receiving the payments:

- to collect late support payments;
- to establish the amount of support payments from a current or former spouse or common-law partner;
- to establish the amount of support payments from the legal parent of that person's child (who is not a current or former spouse or common-law partner) where the support is payable under the terms of a court order;

- to try to get an increase in support payments; or
- to try to make child support non-taxable.

On the other side of the support equation, it is clear both from CRA policy and a number of court decisions that legal costs incurred to defend against claims for support or increases in support are not deductible.

The CRA's position on the deductibility of legal costs incurred in relation to family support matters has evolved over the years in a somewhat piecemeal fashion, and the result has been some degree of confusion over the time periods for which certain changes are effective. Anyone seeking a deduction for legal fees incurred in connection with a family support matter should obtain advice from a tax professional familiar with the facts of the particular situation.

Finally, there is one other situation in which taxpayers may deduct legal fees incurred, and that is in relation to a dispute with the CRA itself. Specifically, fees (including accounting fees) paid for advice given or assistance rendered in relation to a tax assessment or reassessment or the filing of a Notice of Objection or a court appeal are deductible by the taxpayer in the year in which they are paid.