

## LEGAL FEES and CRIMINAL CHARGES

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Given the cost of legal fees, their deductibility is an important issue for most clients. For tax purposes, an individual's business income is his *net* profit from the business, that is, revenues less expenses to earn income. Hence, legal fees to earn business income should be deductible even if they arise from illegal commercial operations that generate taxable income. Legal fees are simply "working expenses" - one incurs them in the process of earning business income. Absent statutory provisions, tax law is neutral and does not morally judge behaviour.

We use the primary purpose test to evaluate the deductibility of legal fees. A taxpayer can deduct legal fees in the normal course of business.

However, legal fees on account of criminal charges are a challenging problem in tax law. Although courts look at accounting and commercial principles to determine business practice, determining net profit is essentially a question of law. One starts by asking whether the taxpayer would have incurred the expense "but for" the pursuit of business income. Would the need to incur the expense exist apart from the business?

White-collar crimes vary considerably in structure. Thus, characterising criminal charges as business or personal is the key to determining deductibility of legal fees, most of which occur in the context of white-collar crimes. Typically, such charges arise out of corporate or personal conduct in the context of illegal combines, price fixing, securities violations, insider trading, unlawful conspiracy to lessen competition, accounting fraud, and income tax evasion. We will see an increasing number of prosecutions for bribery and corruption of domestic and foreign government officials.

Regardless of the context of the offence, the critical element in determining deductibility of legal fees is the primary purpose of the underlying conduct that led to the charges. If the primary purpose of the activity is to earn business income, the expense is deductible unless the expenditure is on account of capital. To be sure, all criminal charges against individuals have some personal consequences - psychological problems, loss of job, financial problems, reputation implications, jail, etc. The key decision, however, is to determine which of the two - business or personal - is the primary reason for the charges.

If the primary purpose of incurring legal defence costs is to preserve business income, the fees are deductible even if there is a secondary personal element for the expenditures. This is essentially a question of fact in each case. The ultimate outcome of the criminal charges - guilty or not guilty verdict - is irrelevant in assessing the deductibility of legal fees.

Businesses are taxable on their income, whether the income flows from unlawful or lawful activities. However, legal fees to defend charges of income tax evasion are not deductible. Tax evasion is not a normal or ordinary incident of carrying on business. The evasion occurs after the income earning process is complete. In *Thiele Drywall*, for example, the taxpayer falsely recorded payments that it made to certain individuals as reimbursements for expenses instead of income for

services. Mis-characterizing service payments as reimbursements is not part of the process of earning business income. The Tax Court disallowed the taxpayer's claim for legal fees because of the underlying nature of the offence.

The issue of deducting legal fees cuts close to the bone if the defendant is a lawyer who faces potential disbarment from the law society. Legal fees to avoid disbarment, or secure reinstatement, as a lawyer may be deductible if they are directly on account of current expenses and not on account of securing a capital asset – the lawyer's licence to practice. It is easier to defend the deduction of fees to prevent disbarment because the expenses are in respect of protecting an asset that the lawyer already has and uses directly to produce business income. Fees to defend personal charges – for example, sexual harassment – that may lead to disbarment from the Law Society are less likely deductible. The potential of disbarment is not sufficiently close to the primary purpose of the expenditure, namely, the defence of the sexual harassment allegations.