Docket: 2004-4028(IT)I

BETWEEN:

MARY FARRELL,

Appellant,

And

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on April 4, 2005 at Victoria, British Columbia

Before: The Honourable Justice Diane Campbell

Appearances:

For the Appellant: The Appellant herself

Counsel for the Respondent: Shawna Cruz

JUDGMENT

The appeals from the assessments made under the *Income Tax Act* for the 1998, 1999, 2000, 2001 are quashed.

The appeal from the assessment made under the *Income Tax Act* for the 2002 taxation year is allowed, without costs, and the assessment is referred back to the Minister of National Revenue for reconsideration and reassessment in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 19th day of May 2005.

"Diane Campbell"

Campbell J.

Citation: 2005TCC352
Date: 20050519
Docket: 2004-4028(IT)I

BETWEEN:

MARY FARRELL,

Appellant,

And

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Campbell J.

[1] It was agreed between the parties at the commencement of the hearing that the taxation years 1998, 1999, 2000 and 2001 were not validly before me as the Appellant had not filed Notices of Objection. In addition, there are no issues to be resolved in these years. The appeals with respect to those years are therefore quashed. The only taxation year before me is 2002.

[2] The Appellant was an employee with the Worker's Compensation Board for the Province of Prince Edward Island when she became medically disabled and unable to continue to work. In connection with her employment, the Appellant was insured against wage loss with Great-West Life Assurance Company (the "Insurer"). She testified however that she encountered a great many obstacles before the insurer paid the claim. During this period she was forced to declare bankruptcy. She hired a law firm to bring legal action to pursue these benefits. The first lawyer she hired did little to assist her or to pursue her claim. Eventually she was forced to hire a second lawyer to pursue the insurers. A settlement was reached and the insurer paid a lump sum amount to the Appellant's lawyer in trust. The settlement amount consisted of the benefits owing under the policy, interest, legal fees and disbursements. In addition to the legal fees that were included in the settlement amount and paid by the insurer ($10,829.64), the Appellant was charged and she paid additional legal fees and disbursements of $12,583.74. It is the legal

fees which the Appellant is attempting to deduct. This deduction has been denied by the Minister of National Revenue (the "Minister") pursuant to paragraph 8(1)(*b*). The Respondent argued that the wording of paragraph 8(1)(*b*) is very clear and strict in its application and prevents the Appellant from deducting the legal fees. The Respondent submitted that it is the last few words of this section that prevents the Appellant from deducting the fees because the legal action is between the Appellant and the insurer and not the Appellant and the employer, the Worker's Compensation Board.

[3] Paragraph 8(1)(*b*) allows for a deduction of legal fees incurred to collect or establish income from "salary or wages". It states:

> 8(1) In computing a taxpayer's income for a taxation year from an office or employment, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto:
>
> ...
>
> (*b*) amounts paid by the taxpayer in the year as or on account of legal expenses incurred by the taxpayer to collect or establish a right to salary or wages owed to the taxpayer by the employer or former employer of the taxpayer;

[4] The definition of "salary or wages" as contained in subsection 248(1) includes "...the income of a taxpayer from an office or employment as computed under Subdivision a of Division B of Part I...". Therefore if an amount is taxable as employment income, any legal fees incurred to collect or establish a right to that amount can be deducted. Whether legal fees are deductible depends on the source of income earned. In general, any reasonable expense can be deducted against business income unless it is specifically restricted under the *Income Tax Act* (the *"Act"*). In contrast taxable income from employment can only be reduced according to certain permitted statutory deductions. Therefore it is important to first determine if the source of income received by the Appellant was from a business or employment. Once this is determined, the deductibility of fees here is determined pursuant to either paragraph 8(1)(*b*) or subsection 18(1). Paragraph 8(1)(*b*) applies where income is determined to be from employment while subsection 18(1) applies to business income. I believe it is clear in this case that the source of income received by the Appellant was from employment.

[5] The Respondent does not dispute that the amounts were paid by the Appellant on account of legal expenses incurred to collect a replacement for lost salary or wages. What the Respondent does dispute is whether it is owed to the Appellant by the Appellant's former employer, the Worker's Compensation Board in accordance with the wording of paragraph 8(1)(*b*).

[6] It is undisputed that the amount was paid by the insurer. The question to be determined is whether the insurer was paying the Appellant, or whether the insurer was paying the Appellant on behalf of the employer. Justice Miller in *Zitko and The Queen*, [2003] 3 C.T.C. 2737 at paragraph 13 stated:

> 13 Were the amounts sought by Ms. Zitko salary or wages owed to her by her employer? Certainly her legal action sought amounts from both the employer and the insurer. Both amounts sought were salary or wages, as the definition of salary or wages reads:
>
> 248(1) In this *Act*
>
> "salary or wages", except in sections 5 and 63 and the definition "death benefit" in this subsection, means the income of a taxpayer from an office or employment as computed under subdivision a of Division B of Part I and includes all fees received for services not rendered in the course of the taxpayer's business but does not include superannuation or pension benefits or retiring allowances;
>
> Amounts brought into employment income under paragraph 6(1)(*f*) fall squarely within this definition. Amounts received under paragraph 6(1)(*f*) are, however, necessarily going to be received from the insurer; paragraph 8(1)(*b*) does not refer to legal expenses incurred for amounts received from the employer - it refers to amounts owed by the employer. If salary or wages, as defined, and as used in paragraph 8(1)(*b*), includes a paragraph 6(1)(*f*) receipt then by implication the salary or wages will be paid by the insurer. That does not preclude a finding something was still owed by the employer. The Respondent argues that the phrase "owed to the taxpayer" is limited by the phrase that follows, "by the employer", and implies that because funds were paid by the insurer, they were not owed by the employer. I disagree. Certainly the insurer paid the paragraph 6(1)(*f*) amounts, but it paid them because the employer contracted with the insurer to pay them. The employer paid the insurer, so that the benefits would be paid. It was part of Ms. Zitko' employment contract that the employer would provide, through a contract with the insurer, disability benefits. While the insurer paid the benefits, it was the employer who owed them in accordance with its employment contract with Ms. Zitko. Just as the Federal

Court of Appeal looks behind a lump sum settlement to the underlying contract to determine the lump sum represents periodic payments for the purposes of paragraph 6(1)(*f*), I have no difficulty in looking behind the insurer's payment to Ms. Zitko at the underlying employment contract to find that the amounts were owed by the employer for purposes of paragraph 8(1)(*b*).

[7] Paragraph 6(1)(*f*) referred to in the above noted paragraph states:

6(1) There shall be included in computing the income of a taxpayer for a taxation year as income from an office or employment such of the following amounts as are applicable:

...

(*f*) the total of all amounts received by the taxpayer in the year that were payable to the taxpayer on a periodic basis in respect of the loss of all or any part of the taxpayer's income from an office or employment, pursuant to

(i) a sickness or accident insurance plan,

(ii) a disability insurance plan, or

(iii) an income maintenance insurance plan

to or under which his employer has made a contribution, not exceeding the amount, if any, by which

(iv) the total of all such amounts received by the taxpayer pursuant to the plan before the end of the year and

(A) where there was a preceding taxation year ending after 1971 in which any such amount was, by virtue of this paragraph, included in computing the taxpayer's income, after the last such year, and

(B) in any other case, after 1971,

exceeds

(v) the total of the contributions made by the taxpayer under the plan before the end of the year and

(A) where there was a preceding taxation year described in clause (iv)(A), after the last such year, and

(B) in any other case, after 1967;

[8] Justice Miller referred to the surrogatum principal as the method used by the Federal Court of Appeal to look "through a contract". This principal was best explained in the case of *London and Thames Haven Oil Wharves Ltd. v. Attwooll*, [1967] 2 All E.R. 124 (C.A.). The Federal Court of Appeal in referring to this principal in *The Queen v. Manley*, [1985] 2 F.C. 208, relied upon the following passage from Diplock, L.J.:

> ... The question whether a sum of money received by a trader ought to be taken into account in computing the profits or gains arising in any year from his trade is one which ought to be susceptible of solution by applying rational criteria; and so, I think, it is. I see nothing in experience as enbalmed [*sic*] in the authorities to convince me that this question of law, even though it is fiscal law, cannot be solved by logic, and that, with some temerity, is what I propose to try to do.
>
> I start by formulating what I believe to be the relevant rule. Where, pursuant to a legal right, a trader receives from another person compensation for the trader's failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits (if any) arising in any year from the trade carried on by him at the time when the compensation is so received, the compensation is to be treated for income tax purposes in the same way as that sum of money would have been treated if it had been received instead of the compensation. The rule is applicable whatever the source of the legal right of the trader to recover the compensation. It may arise from a primary obligation under a contract, such as a contract of insurance; from a secondary obligation arising out of non-performance of a contract, such as a right to damages, either liquidated, as under the demurrage clause in a charter party, or unliquidated; from an obligation to pay damages for tort, as in the present case; from a statutory obligation; or in any other way in which legal obligations arise.
>
> The source of a legal right is relevant, however, to the first problem involved in the application of the rule to the particular case, viz., to identify for what the compensation was paid. If the solution to the first problem is that the compensation was paid for the failure of the trader to receive a sum of money, the second problem involved is to decide whether, if that sum of money has been received by the trader, it would have been credited to the amount of profits (if any) arising in any year from the trade carried on by him at the date of receipt, i.e., would have been what I shall

> call for brevity an income receipt of that trade. The source of the legal right to the compensation is irrelevant to the second problem. The method by which the compensation has been assessed in the particular case does not identify for what it was paid; it is no more than a factor which may assist in the solution of the problem of identification. (Emphasis mind)

[9] I believe it is fair to state that Justice Miller's extension went further than Diplock, L.J. did. However Justice Miller's extension is a reasonable and logical one and I believe that Diplock, L.J. did not make this extension simply because he was not required to do so in the case that was before him.

[10] I recognize that there are cases in this Court which go against Justice Miller's decision. Justice Lamarre in *Marchand v. Canada*, [1995] T.C.J. No. 287 at paragraph 6 states:

> ... it is clear from a reading of paragraph 8(1)(*b*) that the amount thus claimed must be owed by the employer. In the instant case, the appellant did not show that any amount whatever was owed to her by her former employer.

[11] And in *Guenette v. Canada*, [2004] T.C.J. No. 81 Justice Lamarre again took the opportunity to comment on this issue at paragraph 18 where she stated:

> In the first place, disability benefits received by an employee from an insurance company while off work are not salary or wages owed by an employer, as the employee has not rendered any services to the employer during that period ...

[12] The facts in the *Guenette* case can be distinguished because the amounts there would not be taxable as employment income. However it is unclear whether Justice Lamarre's dicta should be taken to suggest that disability benefits are not wages or salary (which they are) or whether she is suggesting that, although they are salary, they do not stem from the employer. In any event her comments in both decisions are dicta.

[13] In the case of *O'Donovan v. R.*, [2001] 2 C.T.C. 2399 (T.C.C.), Justice Beaubier held that wage loss replacement plans do not produce income from an office or employment and therefore paragraph 8(1)(*b*) does not govern the deductibility of the legal fees in dispute. Instead he followed the decision of *Evans v. M.N.R.*, 60 DTC 1047 (S.C.C.). No statutory provision was referred to in *O'Donovan* and I assume the appeal was allowed on the basis that the income was treated as

income from a property. This would enable Justice Beaubier to rely on the *Evans* case, which made references to deductibility of expenses from capital amounts versus deductibility from income from property. Unlike employment income, which can only be reduced through specifically allowed statutory deductions, income from property is the profit that is calculated. Subsection 9(1) includes only the profit of income from property in taxable income and legal fees would be deductible pursuant to the reasoning in the *Evans* case. Justice Beaubier found that the amounts before him were not salary or wages and yet he allowed the deduction. I must disagree with Justice Beaubier's conclusions and particularly so in light of the recent Supreme Court decision in *Tsiaprailis v. Canada*, [2005] S.C.J. No. 9 and in light of the definition in subsection 248(1). It is now clear that insurance payments are a "salary or wage". Although the amount is paid by the insurance company, it is paid to compensate for a salary owed by the employer and should be deductible. I place no reliance on the *O'Donovan* decision because Justice Beaubier did not explain how he moved from finding that paragraph 8(1)(*b*) did not apply and yet the fees were deductible.

[14] In conclusion, I believe that the wording of paragraph 8(1)(*b*) is slightly ambiguous. I am prepared therefore to follow the interpretation and conclusions of Justice Miller in *Zitko*. The facts in Justice Miller's case are very similar to those before me. In addition it is logically consistent with the comments of Diplock, L.J. respecting the surrogatum principal. I am in complete agreement with Justice Miller's comments that paragraph 8(1)(*b*) refers to amounts owed by the employer or former employer – not amounts received from the employer or former employer. The employer contracted with the insurer on behalf of the employee as part of a benefit package negotiated with the employee to pay benefits owed by the employer in the event of disability. There is further evidence of this in the final release (Exhibit R-2) where the Appellant released the insurer:

> ... from any and all actions, causes of action, claims, obligations and demands for damages, loss or injury, howsoever arising, which heretofore has been or hereafter may be sustained or acquired in respect of group policy no. 138410 issued to Workers Compensation Board of Prince Edward Island for the period May 4, 1998 to November 3, 2002 inclusive and in respect of an action brought ...

The Appellant's release is pursuant to the contract between her employer and the insurer as well as the legal action she was forced to take to obtain the benefits. The insurer paid the funds to the Appellant pursuant to the group policy contract but I have no problem looking behind the origin of the benefit funds to the underlying

employment contract and in doing so to find that it is the employer that owed the Appellant.

[15] Therefore the appeal is allowed without costs on the basis that the contract with the insurer to pay the Appellant disability benefits is pursuant to the Appellant's employment contract with the former employer. Since the insurer was paying the Appellant on behalf of the employer, for the purposes of paragraph 8(1)(*b*) the amounts were therefore owed by the employer and consequently the legal fees are deductible.

Signed at Ottawa, Canada, this 19th day of May 2005.

"Diane Campbell"

Campbell J.

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APPEARANCES:

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Counsel for the Respondent:	Shawna Cruz

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