Docket: 2007-4202(IT)I

BETWEEN:

DENNIS A. KEAY,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on July 24, 2008, at Halifax, Nova Scotia

Before: The Honourable Justice Wyman W. Webb

Appearances:

Counsel for the Appellant:	Daniel Wallace and Karen Stillwell
Counsel for the Respondent:	Kendrick Douglas

JUDGMENT

The appeals from the reassessments made under the *Income Tax Act* for the Appellant's 2003 and 2004 taxation years are dismissed without costs.

Signed at Toronto, Ontario, this 28th day of August 2008.

"Wyman W. Webb"

Webb J.

Citation: 2008TCC481
Date: 20080828
Docket: 2007-4202(IT)I

BETWEEN:

DENNIS A. KEAY,

Appellant,

and

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Respondent.

REASONS FOR JUDGMENT

Webb J.

[1] The Appellant claimed $15,065.22 as an expense for legal fees in computing his income from his consulting business in 2004. This claim for legal fees was denied and the deductibility of this amount is the issue in this appeal.

[2] The legal expenses that were claimed in 2004 were incurred during the period from April 29, 2002 to September 29, 2004. It is obvious from the invoice that was rendered by the lawyer that a significant portion of the legal fees did not relate to the 2004 taxation year, and therefore even if the amount incurred was otherwise deductible, it could not all have been claimed in 2004. Counsel for the Appellant acknowledged that the legal fees that were incurred in 2002 could not be considered as part of this appeal as the 2002 taxation year is not under appeal. Counsel for the Appellant argued that the 2003 and 2004 taxation years are under appeal as these were the years that had been reassessed. Since the only issue identified in the Notice of Appeal "is whether the Minister erred by disallowing deduction for Mr. Keay's claimed legal expenses in the 2003 and 2004 taxation years" and since the legal fees were only claimed in 2004, there is an issue whether the 2003 taxation year is under appeal to this Court. As a result of my findings in this case it is a moot point whether the 2003 taxation year is under appeal.

[3] The issue in this case, in relation to the expenses that were incurred in the year or years under appeal, is whether the legal fees were incurred for the purpose of earning income or whether they were personal expenses or expenditures incurred on account of capital. Paragraphs 18(1)(1)(a), (b) and (h) of the *Income Tax Act* ("*Act*") read as follows:

> 18. (1) In computing the income of a taxpayer from a business or property no deduction shall be made in respect of
>
> > (a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property;
> >
> > (b) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part;
> >
> > …
> >
> > (h) personal or living expenses of the taxpayer, other than travel expenses incurred by the taxpayer while away from home in the course of carrying on the taxpayer's business;

[4] The Appellant engaged Gary Manthorne for the services rendered that are the subject of this appeal in April 2002, because the Appellant's then spouse indicated that she was commencing divorce proceedings. A petition for divorce was issued on August 22, 2002.

[5] The Appellant had submitted that since he and his former spouse had entered into a pre-marriage contract, most of the issues arising as a result of the divorce had already been settled. His argument was that the primary issue for which he retained a lawyer related to the rental property that was owned jointly by the Appellant and his former spouse. However when he was asked by his lawyer to describe the legal services that were provided in relation to the rental property, he stated as follows:

> **Q**. Could you -- did he, and, if so, if he did, could you please explain the legal services he provided with respect to the property during the separation?
>
> **A**. Well, I mean, in terms of the property itself, I mean, it's whatever one needs for the notarizing of the documents, and the -- you know, the basic stuff. I mean, there was nothing in terms of re-negotiating the terms of the mortgage. It -- that was only because he had the deeds. He had everything else that was there, and just made life easier.

The other part that went to it was from a business point of view, and that was the other experience that I had had with him, and those were the rationales or reasons that led me to go to him again.

Q. I see.

A. Okay?

Q. Okay. So in regards to -- with your dispute with Ms. Keay, the co-owner of the rental property, what legal services did Mr. Manthorne provide?

A. To be truthful, as little as possible, but it was more so from the point of view -- when I say that, I say that, in part, in -- tongue in cheek. There were a number of things sitting in there, have given me guidance. He knew I knew enough about running a business, so basically a lot of it where there is an upset with a business partner, in this case, my wife, when you're still running a business, there are certain areas of conduct, and you got to do certain things.

When it came to the issues of the opening and closing of the bank accounts, the biggest issue got into it was after all of these things, somewhere along the line, the bank decided they were re-opening the joint accounts.

I've been around long enough, and so has he, and so have most of us in here, that once a joint account is closed, it's closed, okay? And regardless of how good a customer you've been with the Royal Bank for how many years, you just don't do this.

So when I went into my branch, and they said there was nothing they can do, so guess what? I went straight upstairs into the tenth floor, or eleventh floor of the Royal Bank Building, and found myself in this -- couldn't get in anywhere, and somebody came up, "What do you want?" and I said, "I got a fiduciary problem." "Go to your branch." I said, "That's why I'm here."

At which point in time, I sat down with -- I don't know, Dale Baker, I think she was the big boss, and a lawyer. "No, we have to open these." And I said, "Well, I'm sorry, you are not breaking your fiduciary things with me. I've got enough issues as it is. The bank accounts are closed and they're going to be, remain closed. We're going -- if anything has to be established, we do a proper paper trail."

And they were insistent they weren't doing it, so, "What do I need a lawyer for?" Well, it was very simple: guide me; was to get it documented. End of story.

Q. I see. And did you go to -- who did you go for to guide you in document ---

A. Gary.

Q. Gary. If you go to ---

A. Gary Manthorne. I -- Mr. Manthorne, yeah.

[6] On cross-examination the Appellant stated that the primary reason for retaining his lawyer was to enforce his rights under the pre-marriage contract. The following is the exchange between the counsel for the Respondent and the Appellant:

> **Q**. So would you agree that Mr. Manthorne's services primarily included addressing the prenuptial agreement that you had mentioned that you guys executed shortly after the marriage, or before the marriage, as well as the matrimonial assets?
>
> **A**. The joint -- he was -- his primary services were protecting, (a), my pre-existing right that was established by my marriage contract.
>
> **Q**. So that would be the prenuptial agreement, then. Okay, for ---
>
> **A**. Yes. Okay?
>
> **Q**. Same terms. Okay.
>
> **A**. The second thing that was in there, and I think I've said it this morning, in terms of -- part of his major task was that the, my former spouse and her legal counsel/advisors, all were endeavouring to re-characterize my marital, or matrimonial regime as represented by the contract.
>
> The things in there, if you will, that go to a personal issue, and I repeat, they go to the payment in lieu of alimentary support, and they go to all of the household furnishings. That which was joint, jointly owned is represented by the Deeds you see this morning, and everything else over the -- since 1990 is a jointly-owned benefit, or beneficial business. That was the major issue.
>
> And so that you understand a little further, in their Petition for Divorce, okay, my ex-spouse filed for spousal support. When you have -- if you want enforcement of the marriage contract for which the terms for spousal support are fairly clear, then going and asking for something that you've already got is not enforcing an existing right; it's petitioning for more.

[7] To the extent that the legal fees were incurred to prevent his former spouse from establishing her right to spousal support, such amounts would not be deductible. As noted by the Federal Court of Appeal in *Nadeau v. Minister of National Revenue*, 2003 FCA 400; 2003 D.T.C. 5735; [2004] 1 C.T.C. 293:

> 18 Conversely, the expenses incurred by the payer of support (either to prevent it from being established or increased, or to decrease or terminate it) cannot be

> considered to have been incurred for the purpose of earning income, and the courts have never recognized any right to the deduction of these expenditures (see, for example, *Bayer, supra*).

[8] The Appellant submitted into evidence a copy of the invoice issued by Gary Manthorne for his services. However, the Appellant did not call Gary Manthorne as a witness. The only evidence of the services rendered by Gary Manthorne was provided by the testimony of the Appellant, the information contained in the invoice rendered by Gary Manthorne's law firm and copies of letters written by Gary Manthorne. The Appellant's evidence failed to establish that the legal expenses were incurred primarily to earn income or what part, if any, of the legal expenses may have been incurred for the purpose of earning income.

[9] The Appellant testified that there were a number of issues related to the rental property, including issues related to the tenants and ensuring that the mortgage payments were being made. There was no evidence of the amount of the legal fees that were related to the issues concerning the tenants, nor was there any evidence of the amount of legal fees that related to the other particular services that were provided. Reviewing the individual items identified in the invoice rendered by the law firm is of little assistance since the entries are only short summaries of the work. As well, the Notice to Tenant, that the Appellant testified was prepared by the Appellant with the assistance of Gary Manthorne, was dated June 28, 2002 and therefore any expense related to the preparation of this notice would have been incurred in 2002 and would not be deductible in 2003 or 2004.

[10] The following letters written by Gary Manthorne in 2003 or 2004 were submitted into evidence:

(a) a two page letter dated February 20, 2003 which deals with 12 different points including the division of assets, the assumption of liability with respect to the vehicle and the income from the rental property;

(b) a one page letter dated July 2, 2003 dealing with the Appellant's interest in the rental property;

(c) a one page letter dated January 16, 2004 acknowledging the solicitor of record for the Appellant's former spouse and providing the mailing address for Gary Manthorne;

(d) a one page letter dated March 22, 2004 to the solicitor for the Appellant's former spouse which states as follows:

> Further to a letter from The Dominion of Canada Insurance Company dated March 11, 2004, I am writing to inform you that your client is now in arrears on the insurance policy covering the income property situate in Wellington, NS.
>
> Please be advised that your client is the sole recipient of all rental income from said property as per her unilateral decision and is therefore responsible for any and all expenses incurred therefrom.
>
> I have enclosed a copy of the letter and ask that you forward to your client so that we may resolve this matter.

(e) a two page letter dated June 24, 2004 dealing with a call that the Appellant's former spouse had made to the Appellant, requesting information concerning the tenants, raising the issue of whether the Appellant's former spouse had taken possession of the property, dealing with an appraisal of the property and dealing with a proposal that had been made to the previous solicitor for the Appellant's former spouse.

[11] These letters do not support a claim that the total cost of preparing each letter was incurred for the purpose of earning income. The letter of March 22, 2004 does not demand payment from the Appellant's former spouse of one-half of the net rental income from the property but appears to concede that the Appellant's former spouse can retain the income by stating that she is responsible for any and all expenses. It is impossible to determine how much of the time spent in writing any one of these letters that deal with several issues would have been spent on any one particular issue.

[12] There is, however, another significant concern in relation to the deductibility of the legal fees that were incurred. The following are excerpts from the Appellant's testimony during the hearing:

> A:…we're getting into a scenario where, if a divorce was coming, you've got to protect the assets.
>
> Credit reputations have to be protected, and it was as much in my interest as it was in hers to make sure that the credit was protected. It goes to your good name. So I got that rectified.

I don't know what she did with the rest of it, but by the time the Divorce Petition came in, and a lot of other things that were going, it was very clear to myself, and my legal counsel at the time, this was when we really knew what we were up against.

…

Q. Yeah. And you stated that you received the amount just to cover the mortgage payment.

A. That's correct. And that was going to protect the liability, credit reputations. That was the first and foremost part. The second, obviously, you don't pay a mortgage on a rental property; you don't stay in business very long.

…

Q. Okay. Could you just briefly explain if, and if so, how this letter relates to your rental property business?

A. Well, very simply put, it -- the major account in there was going through for the mortgage payments. She wanted to open that up, so that -- by putting the mortgage payments, going back into our joint names, okay? And I'll use that account now, for this.

What was not stated in here, and I can only go from record, because the records, as I say, fell off the truck, at the time -- the records were -- the deposits had been going from a joint account in the TD Bank in to pay the mortgage, and that's what she closed.

So all that I was making sure of is, (a), I did not want to go through the aggravation of more phone calls from the bank, saying the payment hasn't come in, and I've taken full responsibility for it, okay? I just couldn't rely on what was happening, at the time. That was the major purpose behind this.

I mean, to me, the common sense issue in all of this -- you're running a business, and I'll repeat myself -- if you're -- the potential for encumbering a property, or a business, going through foreclosures, I've had all of those routes, and there's just no excuse -- I spent a number of years recovering my credit, my reputation, all kinds of things -- just -- this wasn't happening. That's why this is all happening.

And, really, it -- when you -- asking about this, it -- the personal side of it, if there was a personal side, it's going to my personal reputation running a business; it goes to my personal reputation in my consulting things.

But in terms of this business here, you get into certain other things. Oh, well, they haven't been paying the mortgage. The bank comes to them, "You pay us." I mean, do you see where this goes with the business, and you get liabilities? Uh-uh, wasn't having

anything to do with it.

…
A. And the reason that I was out to do was to protect the business of -- and the income that was coming, to make sure -- I wanted no repeat. I had expressed, from that point, or then on, that I would buy the business, buying the house. To do so is protecting the particular income. That's the way I looked at it.

In -- to the next parts of what -- going on here, part of the things that were ongoing throughout the communications is expressing -- I wanted to get in -- we wanted to get in to do an appraisal. If you're going to go along with this, then let us get in to do the appraisal.

[13] One theme that ran throughout the Appellant's testimony was his concern about protecting the rental asset from foreclosure and potential damage to his credit reputation. He did not want to lose the rental asset as a result of mortgage payments not being made and he did not want to suffer any damage to his credit reputation.

[14] In *Muggli v. The Queen*, [1994] 1 C.T.C. 2705, Justice Bowman (as he then was) stated as follows:

> 9 The real hurdle in the way of the appellant is paragraph 18(1)(b). Even accepting that the cost of protecting his ownership of the farm was an expense or outlay made for the purpose of gaining or producing income, it was, nonetheless, a cost of preserving his ownership of a capital asset. The law is clear that such expenses are on capital account and their deduction is prohibited by paragraph 18(1)(b). This case is in my view squarely within the principle stated by Martland, J. in *Farmers Mutual Petroleums Ltd. v. Minister of National Revenue*, [1968] S.C.R. 59, [1967] C.T.C. 396, 67 D.T.C. 5277, at pages 65–66 (C.T.C. 400–01, D.T.C. 5280):
>
> > It can certainly be said that the appellant, in resisting the lawsuits launched against it, was seeking to protect its income, because it was seeking to protect the assets from which its income was derived. It can, therefore, be argued that the expenses were properly deductible under paragraph 12(1)(a). This is not contested by the respondent. The object and purpose of the lawsuits, however, was to compel the restoration to the land owners of the mineral rights which the appellant had purchased. The learned trial judge has found, and the evidence establishes, that those rights were items of fixed capital, and were so regarded by the appellant. At the time the litigation occurred, the sum total of the mineral rights acquired by the appellant, all of which were of the kind involved in the litigation, represented all of the appellant's capital assets. The appellant did not trade in them, but intended to retain them perpetually.
> >
> > It was to protect those capital assets from attack that the legal costs of the litigation were incurred, and, to quote the words of Dixon, J. (later Chief Justice)

> in *Hallstroms Pty. Ltd. v. Federal Commissioner of Taxation* (1946), 72 C.L.R. 634 at page 650, referring to the costs of defending title to land:
>
> > Next to the outlay of purchase money and conveyancing expense in acquiring the title to land, it would be hard to find a form of expenditure in relation to property more characteristically of a capital nature.
>
> The fact that the leases acquired by the appellant, along with the mineral rights, were more immediately connected with the production of income than was the franchise involved in the Dominion case does not affect the matter in principle. It is relevant in relation to the application of paragraph 12(1)(a), but in relation to paragraph 12(1)(b) we must ask the question, was this outlay for the purpose of preserving a capital asset? In my opinion it clearly was and, if that is so, paragraph 12(1)(b) prevents its deduction.

10 See also, *Brault v. Minister of National Revenue*, [1988] 2 C.T.C. 2316, 88 D.T.C. 1736 (T.C.C.); The Queen v. Burgess, [1981] C.T.C. 258, 81 D.T.C. 5192 (F.C.T.D.).

[15] Since the Appellant had stated on more than one occasion that he was concerned about protecting the rental property from foreclosure and protecting his own credit reputation, this is another reason why the Appellant cannot succeed since, as noted by Justice Bowman in *Muggli*, an expense incurred for the purpose of preserving the ownership of a capital asset is on account of capital and not deductible.

[16] The Appellant has failed to establish what part, if any, of the legal expenses that were incurred, was incurred for the purpose of earning income and not on account of capital and was not a personal expense. In the Reply that was filed the Respondent did not plead paragraph 18(1)(b) of the *Act*, however the Appellant was not prejudiced by this as the Appellant specifically addressed this paragraph in the written pre-hearing submissions of Counsel for the Appellant.

[17] As a result, the appeal is dismissed without costs.

Signed at Toronto, Ontario, this 28th day of August 2008.

"Wyman W. Webb"

Webb J.

CITATION:	2008TCC481
COURT FILE NO.:	2007-4202(IT)I
STYLE OF CAUSE:	DENNIS A. KEAY AND HER MAJESTY THE QUEEN
PLACE OF HEARING:	Halifax, Nova Scotia
DATE OF HEARING:	July 24, 2008
REASONS FOR JUDGMENT BY:	The Honourable Justice Wyman W. Webb
DATE OF JUDGMENT:	August 28, 2008

APPEARANCES:

Counsel for the Appellant:	Daniel Wallace and Karen Stillwell
Counsel for the Respondent:	Kendrick Douglas

COUNSEL OF RECORD:

For the Appellant:

Name:	Daniel Wallace and Karen Stillwell
Firm:	McInnes Cooper

For the Respondent:	John H. Sims, Q.C. Deputy Attorney General of Canada Ottawa, Canada