

# The Cost of Court

## Deductions for earning income

### TAX COURT

BY JAMIE GOLOMBEK



As advisors continue to move from one firm to another, litigation between advisors and their former employers (sometimes) ensues. The costs to defend such litigation, not to mention the cost of any damages found to be owing, can be a significant blow to an advisor, especially as he or she seeks to re-establish their practice at a new firm.

A tax case (*Raphael v. The Queen*, 2008 TCC 202) just released in April 2008, but decided back in 2005, deals with the tax deductibility of both damages and litigation fees in connection with just such a move by an advisor.

In February 1999, Stephen Raphael, a “highly successful stockbroker” living in Westmount, Quebec and described by the judge as “intelligent, ambitious and aggressive,” left his employment with Lafferty, Harwood & Partners Ltd. (“LH&P”) to join RBC Dominion Securities (“RBC”) in order “to increase his income from employment.”

This was demonstrated, in part, by a signing bonus of \$250,000 that he received from RBC upon joining the firm.

At LH&P, in return for 50% of the commissions Mr. Raphael generated, LH&P provided him with office premises, research and support and secretarial assistance. According to his testimony, one of the reasons Mr. Raphael left was “because he believed that the research function there was collapsing.”

When Mr. Raphael left LH&P to join RBC, he did not give any prior notice of termination, a common industry practice when going to a competitor. Most of Mr. Raphael’s clients followed him from LH&P to RBC.

After Mr. Raphael’s sudden departure, LH&P sued him in Quebec Superior Court for lost commissions (the 50%) it could have been expected to earn over the following six months – a period it estimated was a “reasonable notice” period.

In 2001, Mr. Raphael was found liable to pay an amount of nearly \$50,000 to LH&P for damages, plus court costs of \$2,000. He also spent \$22,000 on legal fees to defend his claim,

for a total outlay of \$74,000.

He proceeded to deduct this amount on his 2001 tax return against his commission income from RBC as Mr. Raphael was of the opinion that the \$74,000 expense was incurred solely in connection with the consequences of his resignation from LH&P in order to increase his income, and therefore is deductible under the *Income Tax Act*.

The Canada Revenue Agency

(CRA) objected, saying that the amount paid was not for the purpose of earning income but rather as a consequence of the breach of his employment contract with LH&P. As a result, the CRA felt it was a non-deductible capital expense.

The judge looked at the reasons behind the move, the primary one being to increase his income and provide better services to his clients – something possible due

to the much larger size of RBC.

Not only did Mr. Raphael get the \$250,000 signing bonus, but his payout commission ratio was increased to 55% of his gross commissions, from 50%. He also had access to what he felt were better research facilities.

When Mr. Raphael left LH&P without giving notice, “he took a business risk that he would not have to pay a price for [this] deci-

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**He took a business risk that he would not have to pay a price for his decision.**

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sion.” In the end, however, he did have to pay a total of \$74,000, which “pales in comparison to the \$250,000 bonus he received.”

As the judge said, this was clearly “a business risk worth taking.”

The judge concluded that the \$74,000 he paid was solely for the purpose of earning income and was not a capital expense and therefore, was 100% tax-deductible in 2001. **AER**

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