Docket: 2007-4874(IT)I

BETWEEN:

MARC BEGLEY,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard September 23, 2008, in Ottawa, Ontario.

Before: The Honourable Justice Lucie Lamarre

Appearances:

For the Appellant:	The Appellant himself
Counsel for the Respondent:	Julian Malone

JUDGMENT

The appeal from the assessment established under the *Income Tax Act* for the 2005 taxation year is dismissed.

Signed at Montréal, Quebec, this 6th day of November 2008.

"Lucie Lamarre"

Lamarre J.

Translation certified true
on this 4th day of December 2008.
Elizabeth Tan, Translator

Citation: 2008 TCC 605
Date: 20081106
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BETWEEN:

MARC BEGLEY,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

REASONS FOR JUDGMENT

Lamarre J.

[1] The Appellant is appealing from an assessment established for the 2005 taxation year by the Minister of National Revenue (the Minister) pursuant to the *Income Tax Act* (the ITA). The Appellant declared legal fees of $10,163 when calculating his income for his 2005 income tax report. In court, he produced a letter from his lawyers detailing the fees he paid in 2005, for $12,424.19 (Exhibit A-2). In any event, the Minister disallowed the entire claim for legal fees. They were allegedly incurred by the Appellant to initiate proceedings against his insurer to establish his right to the long-term disability benefits he had taken out with the Canadian Dentists' Insurance Program.

Facts

[2] The Appellant was a dentist and had taken out group insurance in 1982, which included long-term disability insurance for $3,000 a month to the age of 65. He never deducted the premiums he paid for this insurance against his professional income in his tax returns.

[3] In 1994, he was afflicted with a degenerative disease that forced him to end his career as a dentist in 1998. He submitted a claim with his insurer and, after a medical exam, it refused to pay the amount claimed. After the Appellant contested, the insurer offered to pay him a lump-sum amount, equal to one third of the pension the Appellant claimed under his insurance policy. The Appellant refused this settlement. The proceedings against his insurer are still pending before the Superior Court of Québec and a hearing has been set for March 2009.

[4] The documentation submitted to evidence shows that the long-term disability pension sought by the Appellant is considered non-taxable, both by the insurer and the insured (see letter from the Canadian Dental Association to the Appellant, dated July 4, 2007, Exhibit A-2), because insurance premiums paid by the Appellant were not deducted from his income over the years. This is exactly why the Minister disallowed the disability pension that is the subject of the proceedings brought by the Appellant, because it is considered non-taxable.

[5] The Respondent relies on the principle of "revenue neutrality." An amount shall be deductible for income tax purposes if it is incurred for the purpose of earning taxable income.

[6] The Appellant, to a certain extent, relies on the substitution principle, the "surrogatum principle." In his opinion, the disability pension he claims from his insurer is to replace, in part, the professional income he no longer earns because of his disability. Moreover, it seems that the insured amount would not surpass his professional income.

Analysis

[7] The substitution principle was defined by Lord Diplock in *London and Thames Haven Oil Wharves, Ltd. v. Attwooll*, [1967] 2 All E.R. 124 (C.A.)(Div. civ.), and recognized by the Supreme Court of Canada in *Tsiaprailis v. R.*, 2005 SCC 8, at paragraphs 48 and 49:

> 48 …Damage and settlement payments are inherently neutral for tax purposes and must therefore be classified to determine whether they are taxable. This is the *surrogatum* principle, as defined by Lord Diplock in *London and Thames Haven Oil Wharves, Ltd. v. Attwooll*, [1967] 2 All E.R. 124 (C.A.) as follows:
>
> > 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 . . . 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. [p. 134]

> 49 When applying the *surrogatum* principle, the question is what the damage or settlement payment is intended to replace: *Canadian National Railway Co. v. The Queen*, [1988] 2 C.T.C. 111 (F.C.T.D.), at p. 114. It is a factual inquiry: *Prince Rupert Hotel (1957) Ltd. v. Canada*, [1995] 2 C.T.C. 212 (F.C.A.), at pp. 216-17

[8] In *Tsiaprailis*, the taxpayer had brought proceedings against the insurance company to obtain a judgment declaring that she had the right to disability benefits under an insurance policy taken out for her by her employer. She finally settled out of court by accepting a lump sum payment. Abella J. (dissenting) stated the following at paragraph 54:

> 54 applying the *surrogatum* principle to this case, the general nature of the settlement payment was to release the insurance company from a claim that it was liable and, concurrently, to extinguish Ms. Tsiaprailis's claim for entitlement under the disability insurance policy.

[9] Charron J., for the majority, agreed with Abella J. on the principle of substitution in these terms, at paragraph 7:

> 7 …the principle that awards of damages and settlement payments are inherently neutral for tax purposes. My colleague takes no issue with this principle. As she explains, in assessing whether the monies will be taxable, we must look to the nature and purpose of the payment to determine what it is intended to replace. The inquiry is a factual one. The tax consequences of the damage or settlement payment is then determined according to this characterization. In other words, the tax treatment of the item will depend on what the amount is intended to replace. This approach is known as the *surrogatum* principle. As noted by Abella J., it was defined in *London and Thames Haven Oil Wharves, Ltd. v. Attwooll*, [1967] 2 All E.R. 124 (C.A.), and subsequently adopted in a number of Canadian cases: see P. W. Hogg, J. E. Magee and J. Li, *Principles of Canadian Income Tax Law* (4th ed. 2002), at pp. 91-93; and V. Krishna, *The Fundamentals of Canadian Income Tax* (8th ed. 2004), at pp. 413-15.

[10] In this case, the Appellant is seeking to deduct legal fees incurred for his case against his insurer to obtain a judgment granting him the entire disability benefit to which he claims he is entitled under his insurance policy.

[11] For these expenses to be deductible, the Appellant must establish that they were incurred for the purpose of earning revenue from a business or property and that it was not a personal expense. This must be done in accordance with subsection 9(1) and paragraphs 18(1)(*a)* and 18(1)(*h)* of the ITA (see, among others, an analysis on this by the Supreme Court of Canada in *Symes v. R.*, [1993] 4 S.C.R. 695, paragraphs 38 and 40). These provisions state:

> **SECTION 9: Income**
>
> (1) Subject to this Part, a taxpayer's income for a taxation year from a business or property is the taxpayer's profit from that business or property for the year.
>
> **SECTION 18: General Limitations**
>
> (1) In computing the income of a taxpayer from a business or property no deduction shall be made in respect of:
>
> *(a)* **General limitation** – 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;
>
> ...
>
> *(h)* **Personal and living expenses** – 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;
>
> …

[12] It is to resolve this issue that the principle of substitution becomes important. If the disability pension the Appellant is claiming were to substitute his professional income, the legal fees incurred to obtain it would become expenses for the purpose of gaining income to replace business income (in this case the dentist's professional income). As a result, these legal fees would be deductible for tax purposes, but the disability pension would then be taxable. In this way, the principle according to which an amount granted as a benefit is inherently neutral for tax purposes is conserved. On this, I rely on a very recent decision by our Court, *Goff Construction Ltd. v. R.*, 2008 TCC 322, in which Miller J. stated the following at paragraphs 14 and 16:

> 14 …The tax consequences of a settlement payment depend on the tax treatment of the item for which the payment is intended to substitute. Where, as here, the amount is recovery of expenditures, as opposed to lost profits, one must look to the tax treatment of those expenditures. In this case, those expenditures were properly deducted for tax purposes and consequently, applying the *surrogatum* principle, the settlement amount should fall into income…

> 15 This conclusion is not a conclusion that the settlement amount was compensation for current expenses; it is a conclusion that the settlement amount was compensation for deductible capital expenditures.
>
> 16 …The *surrogatum* principle should apply to assist in reaching a tax result in accordance with the tax legislation, not to encourage a result of either windfall at one end of the spectrum, or double taxation at the other end. The *surrogatum* principle should apply to maintain tax neutrality of damages.

[13] If the opposite were true, that the disability pension was not to replace the actual professional income but rather paid on a personal level to compensate the now disabled taxpayer, then it would likely not be taxable. It would not be a benefit received or to be received instead of money that would have been calculated in the business profits.

[14] If this is the conclusion reached, the legal fess would therefore not have been incurred for the purpose of gaining business income (from the dentistry profession), but for personal reasons and would therefore not be deductible for tax purposes.

[15] In the Appellant's case, he stated that the premiums he paid for his insurance policy were not used as deductions against his professional income. This is a sign that the purpose of the Appellant's insurance policy was not to reduce the loss of his professional income. On this, counsel for the Respondent relied on a decision by the Federal Court of Appeal, *Canada v. MacIntyre*, [1975] F.C.J. No. 501 (QL), from paragraph 6:

> 6 My reason for concluding that the premium in question is not an expenditure to earn the income of the "business" is that it is paid as consideration for an insurance policy pursuant to which the respondent is entitled to receive certain fixed weekly amounts for each week that he is "totally disabled and is thereby prevented from working for remuneration or profit" by reason of "disability due to accidental bodily injury", or by reason of "disability due to sickness", and to have such insurance coverage he must be a member of an organization that bargains on behalf of television and radio artists. From this it appears clear that the premiums are in no way laid out to earn the fees paid for the respondent's services (which are the gross revenues of his business); that he must be "totally disabled and ... thereby prevented from working for remuneration or profit" in any week in respect of which he receives the insurance benefit so that, during any such week, he must have suspended or terminated his "business", which consists exclusively in the rendering of his own personal services; and the insurance is not insurance against loss of earnings from the "business"2 but an assurance of payments in respect of a period of disability whether or not the "business" continues in existence.

[16] Similarly in this case, the disability pension is not an insurance against a loss of professional income, but is related to guaranteed payments for the entire period of disability regardless of the Appellant's professional activities. Moreover, even if the reference for setting the amount of the pension is the Appellant's professional income, according to the terms of the insurance policy, this is not a determining factor in itself. As mentioned above, the taxability of the pension depends on its nature and purpose, and what it is intended to replace (see *Tsiaprailis, supra,* at paragraphs 7 and 13).

[17] The disability pension the Appellant is claiming is not a result of his work as a dentist but rather his disability, against which he personally protected himself by taking out an insurance policy. The disability pension is therefore of personal nature and not intended to replace an amount that would have been accounted for as profit from his professional practice.

[18] As a result, the legal fees incurred for this disability pension are not expenses for the purpose of gaining business income or property, and therefore are not deductible under sections 9(1), 18(1)(*a)* and 18(1)(*h)* of the ITA.

[19] The appeal is dismissed.

Signed at Montreal, Quebec, this 6th day of November 2008.

"Lucie Lamarre"

Lamarre J.

Translation certified true
on this 4th day of December 2008.

Elizabeth Tan, Translator

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COURT FILE No.:	2007-4874(IT)I
STYLE OF CAUSE:	MARC BEGLEY v. HER MAJESTY THE QUEEN
PLACE OF HEARING:	Ottawa, Ontario
DATE OF HEARING:	September 23, 2008
REASONS FOR JUDGMENT:	The Honourable Justice Lucie Lamarre
DATE OF JUDGMENT:	November 6, 2008

APPEARANCES:

For the Appellant:	The Appellant himself
Counsel for the Respondent:	Julian Malone

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