Estates Trusts & Pensions Journal

WHAT'S IN A DEDUCTION?

Overview

A trust or an estate is not a legal entity but tax law deems a trust to be an individual for income tax purposes.[1], with the trustee or legal representative being personally liable for the tax. From this perspective, the trust or estate can be treated and examined as a separate taxable entity.

A trust is not the same as an estate [2] but for tax purposes, an estate is treated as a trust for the period in which it takes the executor or personal representative to wind-up the deceased person's affairs and distribute the estate assets to the beneficiaries[3]. While there are therefore legal differences between a trust and an estate, this article will examine the deductibility of certain outlays and expenses by trustees from a tax perspective without distinguishing between a trust and an estate except as otherwise noted.

Since a trust is taxed like an individual, it follows that the general principles relating to the deductibility of outlays and expenses will apply for tax purposes, in the same or similar manner that they would apply for a living individual. That is, in order for an amount to be deductible, it must meet the general tests of

- Being laid out for the purpose of earning income;[4]
- Being reasonable in the circumstances; [5]and
- Not on account of capital

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[1] Subsection 104(2). The precise wording in the Income Tax Act (Canada), is that "A trust shall… be deemed to be in respect of the trust property, an individual". Effectively, a trust is taxed as an individual and Canada Revenue Agency will administer and enforce the Act against the trustee or legal representative and not, the trust itself. However, for most purposes, but not all (such as Section 251.1 for example), the Act imposes the commensurate obligations of an "individual" on the trustee. In some situations, the Act will look to the beneficiaries.

[2] D.W.M. Waters, Mark R. Gillen and Lionel D. Smith, Water's Law of Trusts in Canada, 4th ed. (Toronto: Carswell, 2005), at page 43.

[3] M.N.R. Technical Interpretation 2006-0184741E5. See also the opening words in subsection 104(i), which includes "a reference to the trustee, executor, administrator, liquidator of a succession, heir or other legal representative…" The distinction between a trust and an estate was also drawn in the case of Homer, 2009 Carswell Nat 1313 (TCC), paragraphs 13-17.

[4] Paragraph 18(i)(a) imposes a general restriction that no outlay or expense is deductible in computing the income of a taxpayer from a business or property, except to the extent that it was made or incurred for the purpose of gaining or producing income from the business or property.

[5] Section 67 imposes a general limitation on expenses. No deduction is permitted in respect of an outlay or expense… "except to the extent that the outlay or expense was reasonable in the circumstances".

This article will comment on the deductibility of specific outlays and expenses typical for a trust, including:

- Accounting fees
- Legal fees
- Trustee fees
- Custodial and safe-keeping charges
- Investment counsel fees
- Interest and carrying charges

There might be differing treatment in respect of "income" as determined for accounting and trust purposes, or in respect of a particular outlay or expense reported in the financial statements of the trust, compared to that amount **as** reported for tax purposes.

For instance, a particular expense might be charged against a beneficiary's capital account for accounting purposes, while that same outlay or expense might be deducted against income for tax purposes. Some comments will also be made on this issue as it relates to a trust accounting versus a tax reporting perspective.

Specific Outlays and expenses

1. Accounting fees

    Reasonable expenses paid for accounting fees relating to the recording of investment income and expenses and the preparation of financial records would be deductible in computing the income of a trust. Accounting fees incurred in connection with a plan to effect the distribution of the trust's assets are, strictly speaking on account of capital and would not be deductible in determining the income of the trust[6].

    Note also that:

    > "Reasonable fees and expenses incurred for advice and assistance in preparing and filing of returns for income tax purposes are normally deductible by virtue of Section 9 and are not limited under paragraph 18(1)(a) in computing business or property income to which such returns relate".[7]

    Accounting fees incurred in connection with the earning of income would be deducted against the accounts of the income beneficiaries for accounting purposes, while

[6] M.N.R. Interpretation Bulletin IT-99R5 (consolidated) December 11, 1998 [with subsequent revisions] "Legal and Accounting Fees", at paragraph 1. CRA's view is that except where there is a specific provision in the Act, legal or accounting fees are deductible only to the extent that they are incurred for the purpose of gaining or producing income from a business or property and that they are not outlays of a capital nature. Paragraph 2 of IT-99R5 lists a number of routine business functions where accounting fees would be deductible.
[7] Ibid., M.N.R. Interpretation Bulletin IT-99R5 (consolidated), at paragraph 6.

accounting fees incurred in connection with a non-deductible capital outlay or expense, would be allocated or charged against the accounts of the capital beneficiaries.

Canada Revenue Agency has generally not challenged the deductibility of "reasonable" accounting fees claimed as a deduction against the trust's income, where the expense relates to the compilation of the accounts for the fiscal period, the preparation of the annual financial statements and the T3 Trust Information and Income Tax Return.

There is no general restriction on the deductibility of accounting or bookkeeping fees paid by the trust in this context. Accounting or bookkeeping fees paid to a trustee should be deductible to the trust to the extent that the "limitation" tests are otherwise met. That is, the deduction should not hinge on who is doing the work.

Accounting fees incurred in connection with preparing or instituting an objection or an appeal in relation to an assessment of tax, interest or penalties under the Act, or a provincial act imposing a similar tax, are deductible by the trust. [8]

2. Legal fees

Legal fees incurred in connection with the administration of an estate are, strictly speaking, not deductible for tax purposes. Such amounts represent a payment on account of the capital of the estate and would be restricted by virtue of paragraph 18(1)(b). For accounting purposes, such legal fees should be charged to the accounts of the capital beneficiaries.

However, there are other circumstances where legal fees incurred by an estate or trust will be specifically deductible. These include:

- Collecting or establishing a right to a pension benefit, retiring allowance or severance pay;

  A deduction for legal fees incurred by the estate of a deceased taxpayer, for instance, should be deductible for tax purposes, under subsection 60(o.1).[9]

- Preparing, instituting or prosecuting an objection;

[8] Paragraph 60(o)(i). Note also that CRA has extended the deductibility of such fees to include amounts paid to a taxpayer's professional advisor (i.e. – accountant), in dealing with CRA auditors; for instance where the file is under audit or review. For commentary on this, see M.N.R. Interpretation Bulletin IT-99R5, paragraph 7.

[9] The words in subsection 60(o.1) state "to collect or establish a right to an amount"; therefore, even if the legal action is unsuccessful, the deduction should still be permitted. Note also that 60(o.1) permits a deduction for legal fees incurred in connection with obtaining the right to a "retiring allowance", which could also [by definition under 248(1)], include damages for wrongful dismissal. However, such fees are deductible only against that source of income, and permit only a seven year carry forward.

A trust is entitled to deduct legal expenses incurred in connection with an objection or an appeal in relation to an assessment of tax, interest or penalties under the Act. Note that section 60 permits a deduction "in computing a taxpayer's income for the taxation year", notwithstanding that the amount may not necessarily relate to a particular source of income.[10]

Paragraph 60(o) can be interpreted broadly enough so that a deduction can be allowed to a taxpayer who actually incurs the expense of an appeal or objection, irrespective of the corporate structure under which the taxpayer's interests are held.[11]

- Legal and related costs of obtaining financing;

Paragraph 20(1)(e) permits a deduction for outlays and expenses that are otherwise capital in nature and would generally be non-deductible under paragraph 18(1)(b). Included in this provision are expenses (including legal fees), incurred for the purpose of borrowing money or undertaking a re-financing of debt. These costs are amortizable over a period of five years.[12]

- Legal costs of representation;

Paragraph 20(1)(cc) permits a deduction for costs incurred for the purpose of obtaining "a license, permit, franchise or trade mark" relating to the taxpayer's business. Such a deduction may arise for instance, where a trust incurs legal fees

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[10] M.N.R. Technical Interpretation 2010-03740817 (E) "Deduction of Legal Fees" (September 9, 2010). See also M.N.R. Interpretation Bulletin IT-99R5 "Legal and Accounting Fees", at paragraph 7, which explains that legal fees paid pursuant to paragraph 60(o) can be deducted even where no objection or appeal is actually filed. This should permit the trust or estate to deduct legal fees incurred for advice and assistance in making representations to CRA, or in dealing with tax assessments, even where a formal objection is not filed.

[11] Sherman et al v. M.N.R. [1976] CTC 2207. In this case, the taxpayers were trusts which, after acquiring the shares of certain corporations, proceeded to wind them up and acquire the assets of the underlying companies. The corporations were subsequently re-assessed for tax, and the taxpayer trusts proceeded with the appeals and the related costs of representation. The Minister also sought to disallow the costs claimed by the trusts under paragraph 60(o). However, the Tax Review Board upheld the taxpayers' deduction and concluded that 60(o) was sufficiently broad to include all costs "borne" by a taxpayer to protect their interests. For a more recent citation, see Flood v The Queen, 2006 CarswellNat 829, 2006 TCC 186, 2006 DTC 2775 (Eng), [2006] 3 CTC 2345. The case involved a real estate and trust solicitor who was also the executor and trustee of his mother's estate. An appeal was made by the taxpayer over a dispute in valuation of a real estate property. CRA denied the deduction under paragraph 60(o) on the basis that only his mother's estate could claim the deduction. However, the court held that the representation costs could be deducted by the taxpayer, "if a person has a pecuniary or other interest in the outcome of an income tax assessment, that is not too remote" from the other party. Therefore, the lawyer was not prevented from deducting such expenses under paragraph 60(o).

[12] See M.N.R. Interpretation Bulletin IT-341R4, paragraph 17, for examples of expenses which would qualify under subparagraph 20(1)(e)(ii).

in connection with its business. Note that this provision is not as broad as paragraph 60(o); in contrast, the deduction is limited to those situations where the outlay or expense relates to the taxpayer's business. Therefore, where a trust holds an investment in the shares of a corporation which carries on a particular business, costs incurred under paragraph 20(1)(cc) would generally not be deductible by the trust if such costs were being paid in connection with a business carried on by the corporation.[13]

3. Trustee fees

Trustee fees are deductible under paragraph 20(1)(bb), in respect of a "trustee's general determination of investment strategies, liaison with investment counsel, liaison with beneficiaries, attendance to distribution of income and/or capital, payment of expenses and carrying out other duties of a fiduciary or administrative nature"[14]

There is no specific legislation in the Act which addresses the deductibility of trustee fees in computing the income of a trust. To be deductible, trustee fees must be incurred or paid in connection with the purpose of earning income from a business or property. To the extent that the principal business[15] of the trustee is the provision of advice to other parties or the administration or management of trust property held for the purpose of earning income from a business or property, such fees should be deductible to the trust. Trustee fees paid by a trust might, in some cases, be charged to the capital account of the trust; however for tax purposes, paragraph 20(1)(bb) will permit a deduction from income for tax purposes.[16]

4. Custodial and safe-keeping charges

Fees paid in respect of the custody of securities would generally qualify as a deductible amount under paragraph 20(1)(bb).[17]

5. Investment Counsel fees

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[13] See however CJRS Radio Sherbrooke Ltée v. M.N.R. [1974] CTC 2216 (TRB). Expenses were initially incurred by a group of investors on behalf of a corporation later formed to carry on the business. The expenses were found to be those of the investors and not the appellant corporation. However, the taxpayer's appeal to Federal Court was subsequently allowed by consent to judgment.

[14] M.N.R. Technical Interpretation 2010-038156E5, "Deductibility of Trustee Fee" (February 14, 2011).

[15] See M.N.R. Interpretation Bulletin IT-238R2, "Fees Paid to Investment Counsel" (October 6, 1983), at paragraph 1. For amounts paid to be deductible under paragraph 20(1)(bb), the fees must be paid to a person whose "principal business: is advising others… or whose "principal business" includes administration or management. See also paragraph 2 of IT-238R2, which permits the deductibility of trustee fees from income for tax purposes, even though the amounts may be charged against the capital of the trust.

[16] M.N.R. IT-238R2, at paragraph 2.

[17] M.N.R. Interpretation Bulletin IT-238R2, "Fees Paid to Investment Counsel". (October 6, 1983), at paragraph 4.

Investment counsel fees incurred in connection with advice related to the buying or selling of securities, or for services in respect of the management or administration of the securities held by the trust, are specifically permitted as a deduction under paragraph 20(1)(bb).[18]

To qualify, the fees must be paid to a person whose principal business includes the provision of such services. Provided the amounts paid are reasonable, the total fees can be deducted from the income of a trust, even though part or all of the fees may have been charged to the capital account of the trust.

Fees paid in connection with general financial planning or counseling are not specifically contained within the provisions of paragraph 20(1)(bb), even though the principal business test of the advisor might otherwise be met.

Paragraph 20(1)(bb) excludes commissions which might be paid in connection with the actual acquisition or disposition of securities. Commissions paid on such transactions would be on account of the capital of the trust and would be relevant in determining the adjusted cost base and/or costs of disposition, in respect of the security.

6. Interest and carrying charges

Subject to the general limitations, interest paid or payable by a trust would be deductible in computing income.[19]

The extent and scope to which interest can be deducted has been significantly expanded, thanks in part to court decisions[20] which have also caused CRA to amend its policies on this issue.[21]

It is not the result of the borrowing that is determinative, rather it is the taxpayer's intention in using the borrowed funds that will generally determine whether the interest paid or payable will be deductible in computing income.[22] This test, which applies to individuals and corporations, equally applies to trust. Moreover, the purpose to which the borrowed funds are put, need be only to earn gross income, not net income or even a profit.

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[18] M.N.R. IT-238R2, at paragraphs 1 and 2.

[19] Paragraph 20(1)(c).

[20] In particular, see Ludco Enterprises Ltd. [2002] 1CTC95, where the Supreme Court of Canada ruled that interest paid on a loan used to acquire shares is deductible, even if the shares pay dividends which are less than the interest paid on the borrowed funds. In effect, earning dividends need not be the primary purpose in acquiring the investment; an "ancillary purpose" can be sufficient.

[21] M.N.R. Interpretation Bulletin IT-533 (October 31, 2003), at paragraph 31.

[22] See also Income Tax Technical News ITTN-41, CRA Roundtable 2008 Canadian Tax Foundation Report, at 3:20-22. The taxpayer need only have a "reasonable expectation of income" when the investment is made.

Consequently, where a trust borrows money for the purpose of earning income, the interest paid or payable[23] should be deductible from the income of the trust. This can occur, for instance where the trust holds revenue property with an offsetting mortgage, or where funds are borrowed to acquire stocks, bonds, mutual funds or other similar income-generating assets.

Where paragraph 20(1)(c) does not apply, then the interest expense incurred would generally be considered to be paid on account of capital and not deductible by virtue of section 9.[24]

The treatment of interest expense for accounting versus tax purposes can raise interesting questions in terms of how the financial accounts of the trust should be maintained for each class of beneficiary. For instance, if interest paid or payable is deducted from income payable to the income beneficiary for accounting purposes, but not specifically deductible under paragraph 20(1)(c) for tax purposes, there can be a potential mismatch on the resulting tax consequences. Where the income is retained and taxed within the trust[25], would the tax (on the non-deductible interest expense) be charged to the income or the capital beneficiary? What net amount is payable to the income beneficiary? If the trust's taxable income is fully designated to the income beneficiary, and taxed in their hands, does the income beneficiary bear an additional tax burden that might be more properly allocated to the capital beneficiary?

On the other hand, there may be an argument that borrowed funds were acquired to enhance or build the capital of the trust, but the interest expense is specifically deductible under paragraph 20(1)(c) for income tax purposes. If the interest expense is charged to the capital beneficiary for accounting purposes (but deductible from income for tax purposes), there may be a contrary inconsistency in such treatment and perhaps some tax advantage conferred on the income beneficiary by way of a specific deduction under paragraph 20(1)(c).

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[23] See Crown Forest Industries v The Queen, 2006 CarswellNat 6388, 2006 DTC 2321 (Eng.) [2006] 2CTC 2332, 2006 TCC47, 2006 CCI 47. Paragraph 20(1)(c) permits a taxpayer to deduct interest on either a cash or an accrual basis.

[24] See Bowater Canadian Ltd. v The Queen, 1987 CarswellNat 439, [1987] 2CTC 47, 78 N.R. 140, 12 FTR 318,87 DTC 5287 and also Shell Canada Ltd. v The Queen, 1999 CarswellNat 1808, 99 DTC 5669 (Eng.), [1999] 4 CTC 313, SCC. These court decisions confirm that "in the absence of statutory provisions permitting the deduction of interest, interest is considered a non-deductible capital expense". In effect, the interest "adds to the financial capital" of the borrower.

[25] Subsection 104(13.1)

Income Versus Capital Treatment

In many situations, for instance, in the case of a spousal trust, the income beneficiary can be different from the capital beneficiaries[26]. The respective interests of the income beneficiary and the capital beneficiaries can often conflict. The income beneficiaries will prefer investments that create significant income, whereas the capital beneficiaries will seek re-investment and growth in capital. There can also be differing perspectives with respect to the characterization of trust income and related expenses of the estate or trust for each class of beneficiary.

The "income" of a trust is generally computed without reference to the provisions of the Act.[27] That is, for the purpose of distinguishing "income" from "capital", trust law concepts prevail.

The characterization of a particular expenditure as a current outlay or expense or a capital expenditure is a question of law and fact. There is no single determinative test to identify whether an outlay or expenditure is on account of income or capital, however there has been ample case law over the years to create precedent and set examples to distinguish between capital and income expenditures.[28]

On the whole, the case law dictates that it is the purpose of the expenditure, and not the result of the expenditure, which determines its nature as either an income or a capital outlay.[29]

The "income" of a trust would be determined under trust law. Where the trust reports income and capital gains, trust law should dictate how the receipt of a particular amount is dealt with for accounting purposes unless there are specific terms in the trust which provide the trustee with the discretion to make such determination.

Consider for instance, the case of a qualified testamentary spouse trust, where the terms of trust provide the trustee with discretion to encroach on capital for the benefit of the beneficiary spouse. While all the taxable income would (by definition) be payable to the beneficiary spouse, taxable capital gains realized by the trust would not, strictly speaking, be payable. However, for tax purposes the trustee may wish to exercise the discretion afforded under the terms of trust and actually pay the net taxable capital gains to the spouse, so that the amounts are taxed personally in hands of the beneficiary spouse.

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[26] Subsection 108(1) defines a "capital interest" and an "income interest" of a taxpayer in a trust. A capital interest is effectively any right of the taxpayer as a beneficiary under the trust, other than an income interest. An income interest of a taxpayer is a right, whether immediate or future, and whether absolute or contingent, as a beneficiary of a personal trust, to receive all or any part of the income of the trust, including any right to enforce payment thereunder.

[27] Note that Subsection 108(3) provides that references to income in paragraphs 70(6)(b), 70(6.1)(b), 73(1.01)(c) and 104(4)(a), as well as the definition of "income interest", would be read in its ordinary sense, and computed without reference to the Act. Consequently, these references would not include taxable capital gains. Also, for the purposes of the definition of "income interest" in a trust, income would not include dividends described in Section 83.

[28] Johns-Manville Can. Inc. v The Queen, 2 S.C.R.46 [1985], 2 CTC 111, 85 DTC 5373 would be a leading case.

[29] See for instance Oxford Shopping Centres Ltd. v The Queen [1980] CTC 7,79 DTC 5458 (FCTD), affirmed [1981] CTC 128

Conversely, where discretion is not exercised by the trustee to allocate capital in favor of the beneficiary spouse, the capital gains would accrue to benefit of the capital beneficiaries and would otherwise be taxed within the trust.

There can be anomalies with respect to certain outlays or expenditures of the trust. For instance, legal fees paid by the estate to collect or establish a right to a pension benefit or severance pay are specifically deductible[30] under the Act. However, for accounting and trust purposes, the outlay might be properly treated on account of capital, particularly if the outlay or expenditure resulted in the creation of an asset that previously did not exist.

Where the deduction of an amount for tax purposes confers a benefit on an income beneficiary by reducing the tax otherwise payable, it might be appropriate to consider an allocation of the tax expense for accounting purposes, to ensure an equitable treatment between the income and capital beneficiaries.

Similarly, legal fees incurred by a trust in connection with an objection or appeal might specifically pertain to the interests of the capital beneficiaries, for instance, in dealing with an assessment or appeal pertaining to the receipt of a capital dividend. Such costs are specifically deductible[31] in computing the income of the trust, yet the receipt of the dividend might have been accounted for in the capital of the trust. For accounting and trust purposes, the outlay would be properly charged against the capital beneficiary; of course, the income tax considerations should also be considered by the trustee, so that the "even-hand"[32] rule is maintained.

It is always advisable to maintain separate accounts for the capital and revenue so that outlays and expenditures, together with the resulting tax component are properly recorded in the accounts of the trust.

[30] Subsection 60(o.1)

[31] Paragraph 60(o)

[32] Generally, the "even-hand" rule provides that a trustee has a fiduciary duty to act impartially in regard to the beneficiaries, and to take into account their respective rights. See also Maria Elena Hoffstein, "Selected Non-Tax Considerations in Estate Planning", in the Report of Proceedings of the Fifty-Second Tax Conference, 2000 Conference Report (Toronto: Canadian Tax Foundation, 2001), 31:1 – 86.

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The author wishes to express his appreciation to Kim G.C. Moody, CA, TEP for his assistance in pre-reading this article and with regard to his helpful suggestions on commentary.