

YOUR SETTLEMENT AND TAX



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INTRODUCTION	4
IS YOUR LUMP SUM SETTLEMENT TAXABLE?	5
ARE YOUR LEGAL EXPENSES A TAX DEDUCTION?	6
PREPARING FOR TAX FILING	8
FURTHER REFERENCE FOR TAX PROFESSIONALS	9

This booklet will answer some of your questions about reporting your disability settlement with the Canada Revenue Agency (CRA).

INTRODUCTION

Congratulations on settling your file! Now what about your taxes?

After your disability case has been settled and you have received your lump sum settlement, you may be wondering about the tax implications. Typically, if any portion of your settlement is taxable, you will receive tax forms from the insurance company in the February following the year your case has settled. At that time, you will have to consult with your accountant about filing taxes. This booklet will provide some guidance as to the taxability of your settlement as well as the deductibility of legal fees on your next income tax return.

IS YOUR LUMP SUM SETTLEMENT TAXABLE?

Well, it depends on your disability insurance plan.

The following criteria must be met in order for the arrears portion of a lump sum settlement to be taxable under paragraph 6(1)(f) of the Income Tax Act (see reference on page 10):

- a. The disability plan benefit is payable on a periodic basis in respect of the loss of all or any part of the taxpayer's income from an office or employment;
- b. The employer paid any of the premiums for the plan; and
- c. The benefit exceeds contributions made by the employee towards the plan.

This means that generally, if your disability benefits are non-taxable, then your entire settlement lump sum payment is non-taxable. You do not have to report it to the CRA.

On the other hand, if your disability benefits are taxable, then the portion of your settlement payment that relates to the arrears will be taxable. The remaining amount is non-taxable.

ARE YOUR LEGAL EXPENSES A TAX DEDUCTION?

If your insurance settlement is taxable, a deduction should be available for legal expenses associated with the taxable component of the settlement payment. Where the settlement relates to both taxable (arrear benefit) and non-taxable components (future benefits), it is reasonable to prorate the legal fees accordingly between those two categories.

Whether legal fees are deductible depends on the source of income earned. Paragraph 8(1)(b) of the ITA means that if an amount is taxable as employment income, any legal fees incurred to collect or establish a right to that amount can be deducted.

Deductions allowed

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

Legal expenses of employee

(b) amounts paid by the taxpayer in the year as or on account of legal expenses incurred by the taxpayer to collect, or to establish a right to, an amount owed to the taxpayer that, if received by the taxpayer, would be required by this Subdivision to be included in computing the taxpayer's income;

Geick v. The Queen, 2017 TCC 120 reinforces the fact that legal fees can only be deducted if they were incurred to collect on "owed" amounts from employment pursuant to paragraph 8(1)(b). In *Geick*, the taxpayer incurred nearly \$116,000 in legal fees to defend criminal charges. The court disallowed all the taxpayer's legal expenses as they were incurred solely to protect his future

source of income as a police officer. Legal fees incurred to protect or preserve a future source of income are not deductible. Even legal fees spent to initially defend a termination of employment or seek reinstatement are not deductible.

In *Farrell v. R*, 2005 TCC 352, there was no dispute that the legal fees paid by the taxpayer were “incurred to collect a replacement for lost salary or wages.” Rather, the issue was whether the insurance company was paying the taxpayer directly or simply paying her on behalf of her employer. The court clarified that disability insurance plans involve an employer who has 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. Since the insurer pays the employee disability benefits on behalf of the employer, for the purposes of paragraph 8(1)(b), the settlement amounts are therefore owed by the employer and legal fees incurred to collect said settlement amounts are deductible.

This means that generally, if your insurance settlement is taxable under paragraph 6(1)(f), a deduction should be available in paragraph 8(1)(b) for legal expenses associated with the taxable component of the settlement payment.

PREPARING FOR TAX FILING

If your disability lump sum settlement is taxable, you will receive a T4A slip from the insurer for the taxable arrears for the year in which the insurer paid the settlement amount. The remaining amount of your settlement payment is not taxable.

If you have arrears that represent benefit payments owed for previous years, you may also receive a T1198 Statement of Qualifying Retroactive Lump-Sum Payment form in your closing documents from Share Lawyers, or from the insurance company directly. The T1198 tax form allows you to allocate your settlement funds between the relevant years if you wish – your accountant will be able to advise you on whether you should use the T1198 form.

If you do not receive your tax forms by mid-March of the following year after your date of settlement, please contact our office. We will gladly contact the insurer on your behalf so that you can receive the tax forms before the filing deadline.

Also, please note that under government regulations, the insurer is required to withhold a given percentage of taxable arrears, which are paid directly to CRA.

Your actual tax payable will depend on your overall financial situation. Please note that this is not a standard tax filing, you need to retain an experienced and knowledgeable accountant. Please be sure to provide your accountant with all the settlement documentation (including the Statement of Settlement and Minutes of Settlement), the tax forms as well as this booklet.

FURTHER REFERENCE FOR TAX PROFESSIONALS

For taxation purposes, paragraphs 6(1)(a) and 6(1)(f) of the Income Tax Act (ITA) apply to disability insurance policies.

Amounts to be included as income from office or employment

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

Value of benefits

- (a) the value of board, lodging and other benefits of any kind whatever received or enjoyed by the taxpayer in the year in respect of, in the course of, or by virtue of an office or employment, except any benefit
 - (i) derived from the contribution of the taxpayer's employer to or under a registered pension plan, group sickness or accident insurance plan, private health services plan, supplementary unemployment benefit plan, deferred profit sharing plan or group term life insurance policy,
 - (ii) under a retirement compensation arrangement, an employee benefit plan or an employee trust,
 - (iii) that was a benefit in respect of the use of an automobile,
 - (iv) derived from counselling services in respect of
 - (A) the mental or physical health of the taxpayer or an individual related to the taxpayer, other than a benefit attributable to an outlay or expense to which paragraph 18(1)(l) applies, or
 - (B) the re-employment or retirement of the taxpayer, or
 - (v) under a salary deferral arrangement, except to the

extent that the benefit is included under this paragraph because of subsection (11); or

(vi) that is received or enjoyed by an individual other than the taxpayer under a program provided by the taxpayer's employer that is designed to assist individuals to further their education, if the taxpayer deals with the employer at arm's length and it is reasonable to conclude that the benefit is not a substitute for salary, wages or other remuneration of the taxpayer

Employment insurance benefits

(f) the aggregate of amounts received by him in the year that were payable to him on a periodic basis in respect of the loss of all or any part of his 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 aggregate of all such amounts received by him 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 his income, after the last such year, and

(B) in any other case, after 1971,

Exceeds

(v) the aggregate 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 subparagraph (iv), after the last such year, and

(B) in any other case, after 1967;

In summary, employment amounts payable on a periodic basis in respect of the loss of all or any part of the taxpayer's income from employment, pursuant to a sickness or accident insurance plan or


a disability insurance plan, are included in a taxpayer's income. When an employee or former employee receives disability benefits under such a plan, the benefit amounts are taxable as a benefit of employment after deducting any contributions of the employee to the insurance coverage.

In *Tsiaprailis v. The Queen*, 2005 SCC 8, the Supreme Court of Canada addressed the issue of how to treat a lump sum payment received by an employee from an insurer in settlement of a claim for benefits under a disability insurance plan. The majority applied the surrogatum principle which means that the settlement payment should be taxed in the same manner as the item for which the payment is intended to substitute.

There are three components of a disability settlement lump sum payment to consider: (1) the amount claimed for accumulated arrears owed up to the date of settlement, (2) the claim for future payments, and (3) an amount for legal costs (*Frizzle v. R*, 2008 TCC 651).

The majority held that clearly the portion of the settlement representing arrears of period disability benefit payments was paid pursuant to the disability plan, not pursuant to the settlement agreement between the taxpayer and the insurer, as it was intended to replace past disability payments. Since the disability benefits in this case were taxable under paragraph 6(1)(f), the majority held that the arrears portion was taxable.

The majority also held that monies paid in settlement of any future liability under the disability insurance plan were not paid "pursuant to" the plan because there is no obligation to make such a lump sum payment under the terms of the plan. Therefore, the part of the settlement for future benefits is non-taxable under s. 6(1)(f).



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