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Budget 2017 Update - Relief for contingency fee engagements

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As proposed in the March 22, 2017 budget, every professional must include year-end work-in-progress (WIP) into taxable income effective for taxation years beginning after March 21, 2017. WIP for professionals typically represents unbilled professional time and cost incurred in the rendering of services to clients. This is often captured in the form of a professional's "charge-out" rate, which represents their cost, overhead and some profit component.

What are the pre-budget rules and impact?

Provisions in the Income Tax Act previously allowed certain professionals (accountants, dentists, lawyers, medical doctors, veterinarians and chiropractors) who complete work over months or in some cases years to defer taxation on the associated income until the work was completed and invoiced. This allowed professionals to better match the recognition and payment of tax with the cash receipts for a particular taxation year.

What are the post-budget rules and impact?

The new rules propose to do away altogether with the WIP deduction noted above.

The policy change results in an acceleration of tax collection, but the total amount of tax effectively remains the same such that professionals should not be worse off on a total tax basis with respect to any particular billing. However the up-front cash impact can't easily be ignored for many professionals who work on a contingency fee basis (i.e. professionals working on personal injury cases and class actions) and would have been required to finance the accelerated tax liability even where ultimate collection and amounts remained uncertain or undeterminable until a future time.

On Friday April 28th, 2017 the CRA clarified via their website that WIP in respect of *bona fide* contingency fee arrangements would not be required to be recognized into income. Accordingly, the CRA has indicated that they do not anticipate the budget changes with respect to WIP will impact contingency fee arrangements. They have further indicated that any expenses incurred with respect to such engagements will continue to be deductible for the period in which they are incurred providing that the client has no obligation to the professional to reimburse their expenses until some successful future outcome is obtained. While it remains unclear if this release represents a CRA administrative position or a potential change in the proposed legislation, it is certainly welcomed news to those in the professional community that work on contingency fee assignments.

For those professionals that do not meet the criteria, the proposed changes to WIP will be phased in over the course of two years as follows to provide some relief:

1. In year 1 (i.e. for December 31 year ends, the first year of impact will be December 31, 2018), professionals will have to include 50% of WIP in taxable income.
2. In year 2 (i.e. for December 31 year ends, December 31, 2019) professionals will have to include 100% of WIP in taxable income.

What can be done for non-contingency fee engagements?

1. Appropriately value WIP that needs to be included in taxable income. For income tax purposes, WIP may be valued at the lower of cost or fair market value provided such method of reporting remains the same each year. While "cost" is generally lower than market, the exercise to determine the cost associated with an engagement can prove to be a monumental task to undertake for each ongoing client engagement at year end. Similarly, assessing fair market value of WIP for a particular engagement may be equally

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complex where collection and recovery will not be known until a later date. Notwithstanding the complexities, the lower of cost or fair market value approach does present an option for professionals to reduce the amount of WIP that they would be required to include in income.

2. Consider establishment of a professional corporation to reduce the upfront tax on WIP that needs to be included in taxable income. Professionals that earn income through a professional corporation will be able to access the lower rate of corporate tax of 26.5% vs the personal tax rate on the same income of 53.5% (top rates – Ontario).

3. Accelerate billing and collection on other accounts where possible. Consider accounts which may be interim billed or invoiced in order to provide additional cash flow to finance the tax liability on WIP related to contingent accounts.

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