

September 2017

## Budget 2017 Update – Extended transitional period for work in process of professionals

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An *earlier version* of this Tax Flash was originally published on May 11, 2017. The following version has been amended to reflect important updates as of Sept. 8, 2017.

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 such time as 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 upfront cash impact can't easily be ignored for many professionals (particularly those individuals working on a contingency fee basis for personal injury cases and class actions) that may have been required to finance the accelerated tax liability with ultimate collection of associated revenues remaining undeterminable until a future time.

On Friday, April 28, 2017 the CRA clarified via its 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 it does not anticipate the budget changes with respect to WIP will impact contingency fee arrangements. The CRA has 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 in respect of the 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 welcome news to those in the professional community who work on contingency fee assignments.

### SEPTEMBER 8 UPDATE

On September 8, 2017 the Department of Finance released draft legislation for public comment which included additional relief for WIP of professionals. The original budget announcement provided for a 2-year phase-in period for the new rules allowing professionals to reduce some of the upfront impact of the changes. The September 8, 2017 draft legislation now contemplates a 5-year phase-in period. The changes will operate as follows for taxation years beginning after March 22, 2017 (in most instances the first year of impact will be the year ending December 31, 2018):

1. 1<sup>st</sup> taxation year – 20% of the lower of cost or fair value of unbilled WIP included in income

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2. 2<sup>nd</sup> taxation year – 40% of the lower of cost or fair value of unbilled WIP included in income
3. 3<sup>rd</sup> taxation year – 60% of the lower of cost or fair value of unbilled WIP included in income
4. 4<sup>th</sup> taxation year – 80% of the lower of cost or fair value of unbilled WIP included in income

For the 5<sup>th</sup> taxation year the full amount in respect of WIP must be included in computing the income from a professional business. The relief is only available where the taxpayer elected to exclude WIP in computing income in the last taxation year that begins before March 22, 2017 and only applies to income of a business that is a professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian or chiropractor.

The extension of the transition period from 2 to 5 years provides professional firms with the opportunity to absorb the tax impact of these changes over a longer time horizon to better manage the cash outlay associated with any additional tax liability.

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