The Joint Committee on Taxation of
The Canadian Bar Association
and
Chartered Professional Accountants of Canada

Chartered Professional Accountants of Canada, 277 Wellington St. W., Toronto Ontario, M5V3H2
The Canadian Bar Association, 500-865 Carling Avenue Ottawa, Ontario K1S 5S8

May 31, 2017

Brian Ernewein
General Director
Tax Policy Branch
Finance Canada
90 Elgin Street
Ottawa, ON K1A 0G5

Dear Mr. Ernewein:

Subject: Federal Budget 2017 - Proposed Amendments to Taxation of Work In Progress ("WIP") for Professionals

We are enclosing a submission which considers the proposed changes to the *Income Tax Act* (the "Act") as they relate to the repeal of section 34 of the Act.

The 2017 federal Budget proposes to abolish paragraph 34(a) for taxation years that begin after March 21, 2017. If enacted, this will require professional businesses that previously qualified for the election under paragraph 34(a) to include their year-end WIP in income, either at the lower of cost or fair market value (FMV), or at FMV as prescribed by section 1801 of the *Income Tax Regulations*. The Joint Committee appreciates the overall policy rationale for this proposal, namely that recognition of revenues should not be deferred while associated expenses are deducted. However, the Joint Committee believes that a number of uncertainties and compliance burdens will result from the proposal, which can be alleviated with further legislative guidance, a de minimis test and a longer transitional period. We wish to point out that similar amendments were proposed by both the Carter Commission and the 1981 federal Budget but, for reasons similar to those described herein, the proposals did not proceed.

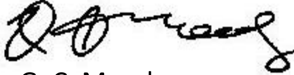
Thank you for your consideration of this matter. A number of members of the Joint Committee and others in the tax community have participated in the discussions concerning our submission and have contributed to its preparation, in particular:

Bruce Ball (BDO Canada LLP)
Marlene Cepparo (KPMG LLP)
R. Ian Crosbie (Davies Ward Phillips & Vineberg LLP)
Rose Cross (BDO Canada LLP)
Heather Evans (Canadian Tax Foundation)
Dean Kraus (Stikeman Elliott LLP)
Kim G. C. Moody (Moodys Gartner Tax Law LLP)
K.A. Siobhan Monaghan (KPMG Law LLP)
Hugh Neilson (Kingston Ross Pasnak LLP)
Angelo Nikolakakis (EY Law LLP)

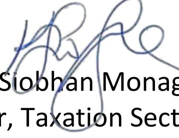
Gabe Hayos (CPA Canada)
Kenneth Keung (Moodys Gartner Tax Law LLP)
Kelly Kolke (Grant Thornton LLP)
Edward Rowe (Osler, Hoskin & Harcourt LLP)
Mitch Sherman (Goodmans LLP)
Jeffrey Trossman (Blake Cassels & Graydon LLP)

We trust that you will find our comments helpful and would be pleased to discuss them further at your convenience.

Yours very truly,



Kim G. C. Moody
Chair, Taxation Committee
Chartered Professional Accountants of Canada



K.A. Siobhan Monaghan
Chair, Taxation Section
Canadian Bar Association

Cc: Ted Cook, Director, Tax Policy Branch, Finance Canada
Gabe Hayos, Vice President, Taxation, CPA Canada

Federal Budget 2017 - Proposed Amendments to Taxation of Work in Progress ("WIP") for Professionals
Joint Committee on Taxation Submission
May 31, 2017

The 2017 Federal Budget contains a proposal to repeal section 34 of the *Income Tax Act* (the "Act"). That provision permits the income of certain designated professionals to be computed on the basis that work in progress ("WIP") at the end of the year may be excluded from income.[1] Once an election is made under paragraph 34(a), it applies for all succeeding taxation years unless the Minister of National Revenue agrees the election may be revoked. If the Act is amended as proposed, the WIP of the designated professions will be deemed to be inventory by virtue of paragraph 10(5)(a) and, accordingly, for the purpose of computing income from the practice, will be required to be valued at the lower of cost or fair market value ("FMV"), or in a prescribed manner.

The Joint Committee on Taxation (the "Committee") respectfully makes the following submissions with respect to the proposed repeal of section 34.

Costing of Work in Progress

Where a professional chooses to value his, her or its WIP under the lower of cost or FMV method, the cost of the WIP must be determined. There is no legislative guidance in the Act on the meaning of "cost" in this context. Subsection 248(1) defines "cost amount", and in the context of inventory, it is the value at that time as determined for purpose of computing the taxpayer's income. However, that definition does not provide any guidance on "cost' and thus is not directly applicable for purposes of section 10. The Committee is unaware of any published case law on the costing of WIP of a service provider, and in particular, the WIP of a professional business.

According to the Supreme Court of Canada's decision in *Canderel*,[2] in seeking to ascertain profit under section 9, the goal always should be to obtain an accurate picture of the taxpayer's profit for a given year, and the taxpayer should be free to adopt any method not inconsistent with the provisions of the Act, established case law principles and well-accepted business principles (including but not limited to the generally accepted accounting principles (GAAP)). Based on *Canderel*¸ professionals have latitude in choosing an appropriate method of costing, since no case law or provisions in the Act deal specifically with the matter and there is likely no commonly accepted approach to costing a designated professional's WIP given the current reliance on section 34. We expect that professionals who are not covered by existing section 34, such as engineers, architects, etc., tend to progress bill and have a better measure of the proportion of a job that is completed.[3] Designated professionals who rely on section 34 have not previously had a need to address the issue of what constitutes the cost of WIP.

---

[1] Section 34 applies to the professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian or chiropractor.

[2] *Canderel Ltd.* v. *R.*, [1998] 1 S.C.R. 147.

[3] We acknowledge this also may be true of some professions that currently enjoy the benefit of section 34.

Although GAAP is not the only source of guidance to consider in determining how to measure cost, it nonetheless is a useful guide. Under both the International Financial Reporting Standards (*IFRS*) and accounting standards for private enterprises (*ASPE*), the cost of inventory generally includes direct costs such as direct labour and some sort of systematic allocation of fixed and variable production overhead. Regarding the cost of inventories of a service provider, paragraph 19 of the International Accounting Standards 2 (IAS 2) notes the following:

> "*To the extent that service providers have inventories, they measure them at the costs of their production. These costs consist primarily of the labour and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads. Labour and other costs relating to sales and general administrative personnel are not included but are recognised as expenses in the period in which they are incurred. The cost of inventories of a service provider does not include profit margins or non-attributable overheads that are often factored into prices charged by service providers.*" [Emphasis added]

Unfortunately, ASPE, the accounting methodology used by most professionals in Canada, does not include similar guidance for service providers. Nevertheless, the passage from IAS 2 quoted above describes one of the methods that a professional business might employ to obtain an accurate picture of profit.

Alternatively, instead of using actual costs, IAS 2 also permits the use of other methods for determining cost, the most applicable one being the "standard cost method" which takes into account the normal level of material and supplies, labour, efficiency and capacity utilization to measure the cost of WIP.

Notably absent from GAAP is specific guidance on 1) how "normal level of activity" should be determined for a service provider and therefore how overhead expense should be allocated, and 2) how and whether to allocate costs associated with time spent on projects by owners who do not draw salary from the service provider. There is also little or no direction on how to apply this guidance to a professional firm.

While the lack of guidance provides flexibility for professionals to choose the costing method most appropriate to reflect an accurate picture of their profits, for most small to medium size professional firms, this potential range of options represents an overwhelming uncertainty and a considerable compliance burden. Many professional firms in Canada that relied on section 34 do not currently have the necessary cost accounting experience, systems or resources to extract from their standard billing rates the appropriate amount of direct costs and allocable overheads. We anticipate that the Canada Revenue Agency ("CRA") will face similar challenges in administering and enforcing the proper reporting of WIP.

The CRA has in the past issued administrative guidance on acceptable costing methods for WIP, such as in paragraph 12 of Interpretation Bulletin IT-473R released on December 21, 1998 and CRA document #5-8507 released on September 19, 1989. In these publications, the CRA expressed the following views:

- The cost of WIP means the total of the laid-down cost of materials, the cost of direct labour (including benefits) and the applicable share of overhead expense properly chargeable to production;
- Either direct costing (allocates variable overheads to inventory) or absorption costing (allocates variable and fixed overheads to inventory) are acceptable but the method used should be the one that gives the truer picture of the taxpayer's income;
- Prime cost, a method where no overhead is allocated, is unacceptable;
- A taxpayer is not required to include in WIP any fixed or indirect overhead costs, such as rental, secretarial and general office expenses, or any imputation of the cost of the partner's or proprietor's time.

While the historical CRA guidance is helpful, it is not binding on the CRA or taxpayers, and is subject to change over time. Moreover, it is not specific in terms of how overhead should be computed and allocated (or which overhead is fixed or variable), leading to the same uncertainty and compliance burden issues mentioned above.

We would like to direct your attention to the work already done by the Department of Finance (the "Department") in 1981 and 1982 when section 34 and paragraph 10(5)(a) received their last major amendment. At that time, submissions were made by the Canadian Bar Association ("CBA") expressing many similar concerns to those expressed in this letter, and the Department published a report on December 18, 1981 attempting to address these concerns.[4] In the report, the Department announced that the cost of WIP would not include (i) fixed or indirect overhead costs, such as rental, secretarial, and general office expenses, or (ii) the cost of the time of partners or proprietors. We have enclosed a copy of this report and the CBA submission for your reference.

The 1981 proposed legislative clarification of the measurement of cost for WIP was ultimately abandoned when final legislation was introduced in 1982. Presumably, the Department decided such clarification was no longer needed since the section 34 amendments introduced in 1982 exempted accountants, dentists, lawyers, medical doctors, veterinarians, and chiropractors from having to include year-end WIP in their income.

We respectfully suggest that legislative or regulatory guidance on the measurement of cost should be introduced concurrently with the repeal of section 34. This will provide considerable certainty and simplicity for professionals and the CRA in complying with the new requirements, as well as minimize disputes between taxpayers and the CRA. Possibilities include:

- Legislated or regulatory exclusion from WIP similar to what the Department contemplated in 1981, i.e. excluding from WIP any (i) fixed or indirect overhead costs, such as rental, secretarial, and general office expenses, and (ii) cost of the time of partners or proprietors;
- Legislated or regulatory description of one (or more) costing methodologies; or

[4] Office of the Honourable Allan J. MacEachen, Deputy Prime Minister and Minister of Finance, Release, no. 81-126, "Notes on Transitional Arrangements and Adjustments Relating to Tax Measures Announced November 12, 1981," December 18, 1981.

- Legislated or regulatory “simplified proxy method” which the taxpayer could choose, but would not be obligated, to use. For instance, the proxy could be the direct wages expended in acquiring the WIP, plus a legislated percentage to represent benefits and variable overheads.

Transitional Period

The proposal to eliminate the exclusion of WIP from the income of certain professionals includes transitional relief; although the measure will apply immediately, to taxation years which begin on or after March 22, 2017, only 50% of the lesser of cost and FMV (or 50% of the FMV, under the prescribed method) of WIP is required to be included in income for the first taxation year that is subject to these rules. We understand that this limited transition period has been proposed to mitigate the effect of the proposals. However, we believe that this is not an adequate transition period.

Although the calculation of WIP varies amongst practices, it is likely the case that many (perhaps most) partnerships and individual practices have WIP balances that have built up, incrementally, over many years. For example, although WIP may vary from year to year as a result of the effects of particular files, it is our experience that over time WIP will reflect a relatively consistent percentage of revenues. For most professional practices that are successful, there would have been a growth in revenues over time. Given the long history to the exclusion of WIP, many businesses have built up relatively large WIP balances through the growth of their revenues. Accordingly, even in an established practice with a steady and predictable workload, it is possible that WIP will increase even if only by small amounts from year to year, reflecting mostly rate increases over time. This gradual accretion to WIP creates two distinct but related issues. First, the savings from the WIP created many years or decades ago would not be reflected in current available cash that may be generated immediately to pay the additional tax liability that will arise under the proposals. Second, many larger firms with numerous partners that come and go may not have tracked WIP to specific partners, having regard to the small effect of incremental WIP changes from year to year. We have provided some examples in the Appendix to illustrate these consequences.

Accordingly, for most longstanding practices, unwinding the deferral resulting from the build up of a WIP balance could result in a very large tax liability relative to the practice’s current cash flow (which itself is fully taxable). This additional liability for tax may be quite onerous if it can only be spread over two years. For large and mid-size firms, many of the primary beneficiaries of the WIP deferral may no longer be with the firm and, as a result, the current and new partners who have had limited or no benefit from the WIP deferral will bear the entire cost of unwinding the deferral. While these firms could have tracked WIP to specific partners, the legitimate expectation that the current rules would not be changed, together with the relatively small impact of annual incremental changes, made such tracking seem unwarranted in the circumstances. Because the proposals will now cause the full deferral to be borne by the current and new partners of such firms, we believe that it is both fair and appropriate to permit a longer transition period in order to diffuse the effect of such consequences.

Many firms must also consider how they will amend partnership agreements to reflect the change in tax law. This will take some discussion and consideration to establish what is acceptable for each partnership. We expect that in some cases this process will be difficult and potentially controversial,

because consideration will have to be given to both (i) the allocation of the WIP balance that has built up over years among current partners and (ii) what approach to take to allocating the WIP going forward, particularly since the nature of the work of some members of a partnership may be more prone to significant delays between the creation of the WIP and billing (e.g., litigation) than others. Accordingly, this change is anticipated to affect many issues in the relationship among partners including the capital required from partners, and the timing and amount of distributions.

Moreover, professional practices affected by this proposal will have to select a measurement method, both in terms of deciding whether to measure WIP at the lower of cost or FMV, or at FMV as permitted by section 1801 of the Income Tax Regulations, and in terms of the method of determining FMV and/or cost. The methodology selected for the first year beginning or after March 22, 2017 must be followed consistently in subsequent years, unless the professional practice obtains an explicit concurrence from the Minister of National Revenue CRA to adopt another method. Many small and medium sized professional practices, which have not devoted time and resources to navigating the tax implications and nuances of the taxation of WIP, are likely to simply report their year-end WIP at gross billing value (analogous to the fair market value of work in progress of a professional as presently defined in paragraph 10(4)(a)) in that first year to avoid complexity. (Indeed we suggest there is a lot of confusion about the rule with many practitioners not understanding there is a choice of methods.) By doing so, they would have "locked in" the prescribed method and will not be able to avail themselves of the lower of cost and FMV method in the future, unless the Minister of National Revenue provides its consent. In order to provide professional practices with sufficient time to navigate these rules, we would respectfully suggest that the methods of valuation not be required to be fixed until the year after the end of the transition period.

Moreover, as noted above, this does represent a significant change for many professional practices and will require time to identify the most appropriate method for valuing WIP and determining the cost of the WIP and, having made that decision, to implement accounting systems and IT system changes necessary to be able to identify and appropriately track the relevant information.

For these reasons, we believe that a longer transition period is warranted in the circumstances. Changes to other deferral rules in the context of partnerships have benefited from a 10-year transition period in some cases and five-year transition period in others. While we acknowledge that the 1981-82 changes to the taxation of WIP provided for a two-year transition period, that period was considered too short even then.[5] It seems less appropriate in 2017 given that existing WIP may have built up over a period of more than 40 years,[6] many partners will have joined or left firms in that period, and many firms will have grown in size over that period.

[5] We observe that the 1982 submission the Canadian Bar Association made to the Standing Committee on Finance, Trade and Economic Affairs suggested a 10-year transition period, as an alternative to the submission that the proposal not apply at all to WIP balances at the end of period preceding the effective date of the change. The CICA's 1981 letter to the Minister of Finance regarding the 1981 proposals expressed the view that the change should be phased in over a number of years, without suggesting what the number should be. In the end, the proposal did not proceed with respect to the designated professionals.

[6] For those affected by the 1981 changes, the WIP would have built up over a maximum of 10 years.

Having regard to the considerations described above, we would respectfully suggest that consideration be given to a 5-7-year transition period for the proposals, better matching the transition period to the forecasting period used for the purposes of the Budget while at the same time easing the burden on the affected professionals in a manner that would not unduly affect the Government's overall budgetary planning and presentation.

***De Minimis* Exception**

We understand that accountants and lawyers in small practices may have a materially different WIP profile than do other small-practice professionals and other service businesses. In particular, it is not unusual for accountants and lawyers in small practices to "carry" clients for a significant period of time in respect of certain types of matters, perhaps until the matter they are involved in (a divorce, a lawsuit, a consulting project) is substantially or completely resolved. This is likely to be a function of the nature of the work, which can be protracted, and the nature of the client-professional relationship. Whereas other small businesses typically may have a few weeks of WIP, these practitioners may have WIP representing months and sometimes years of work. In this case, the certainty and timing of collection of the WIP may be questionable, and the financial burden of moving to taxation based on the 2017 Budget proposals may be significantly more material to these small practices. In addition, to date, these smaller professional practices may have had no need to track WIP, or the costs associated with WIP, on a basis that is useful for the changes proposed in the Budget. In the context of a small practice, the changeover in information collection and reporting may be a significant change, with associated costs in time and money.

We encourage the Department to consider whether it is appropriate to provide an exception from the Budget proposals for small practices for these reasons. Many small legal and accounting practices generate modest earnings, and we encourage the Department to consider whether it will achieve its principal objectives with respect to the proposals without subjecting these practices to the changes.

Such an exception could look to the reporting thresholds adopted by the CRA for T5013 reporting as a starting point. The CRA excepts partnerships from T5013 reporting requirements where they have aggregate revenue and costs (in absolute terms) below a $2,000,000 threshold.[7] By including both revenues and costs, this threshold will except only small practices. The $2,000,000 threshold adopted by the CRA is a pre-existing guideline, but another threshold easily could be adopted if it were considered more appropriate. This approach would apply the threshold at the level of the firm, and not at the level of the individual partner. While, as a result, this will apply in different financial circumstances to, for example, a sole proprietorship as compared to a three-person partnership, it keeps the focus on small businesses. The Department may consider this approach to be an acceptable one in order to achieve simplicity. The T5013 exception is applicable to partnerships but is not relevant to sole practitioners. In the context of an exception to the Budget proposals, no similar distinction would be made.

In order to achieve continuity, and recognizing that revenues may vary significantly from year to year in small practices, we further encourage the Department to consider that the threshold be applied against the average of revenues and costs over a number of years (or such shorter period as the practice has

[7] See Canada Revenue Agency News Release dated September 17, 2010.

been operating in the case of new practices). For example, a rule could provide that a taxpayer be excepted from the Budget proposals where the average of the annual aggregate revenues and costs over the preceding five years was not more than $2,000,000.

Valuation of Work in Progress for Contingent Fee Arrangements

Significant uncertainty exists with respect to how WIP of a professional that relates to a contingent fee arrangement should be valued under the rules, as modified by the proposed changes. Such contingent fee arrangements are common in both the legal and accounting professions. These arrangements (and other deferred payment arrangements) assist clients who otherwise may not have the ability to pay for the services.

In a recent FAQ published on the Canada Revenue Agency ("CRA") website, the CRA sought to address this uncertainty by making the following statement:

> *Under the terms of a contingency fee arrangement, all or a portion of a designated professional's fees may only become known and billable at some time after the taxation year in which the professional provided services under the arrangement (e.g., where, under the terms of a written contingency fee agreement between a personal injury lawyer and a client, legal fees are only billable by the lawyer on a periodic basis as amounts are received by the client under a negotiated settlement or a court judgment). Until such time, there is often no liability on the professional's client to pay any fee; consequently, no amount is receivable by the professional until the right to collect the amount is established. Under these circumstances, for purposes of determining the value of the professional's work in progress at the end of the year, no amount would normally be recognized. As a result, the proposed change to eliminate the ability of designated professionals to elect to use billed-basis accounting is not expected to have any impact on these types of contingency fee arrangements where the terms and conditions of such arrangements are bona fide.* FN: http://www.cra-arc.gc.ca/gncy/bdgt/2017/qa11-eng.html

It is laudable that the CRA would attempt to address the uncertainty arising with respect to contingency fee arrangements and their comments in this regard are certainly welcomed by taxpayers affected by the Budget proposals. However, the legal basis for the position that WIP may be valued at nil to the extent that it relates to a fee arrangement in which the client does not have a legal obligation to pay a fee to the professional until a specified event occurs is not clear.

The basis for the statement appears to be that the professional would not have an amount that is receivable until a right to collect the fee exists. However, paragraph 10(4)(a) of the Act states that, for the purpose of determining the value of inventory under subsection 10(1), the FMV of property that is "*work in progress at the end of the taxation year of a business that is a profession means the amount that can reasonably be expected to become receivable in respect thereof after the end of the year.*" This language suggests that the valuation of WIP in this context should be determined based on what the professional can reasonably expect will be collected in respect of the fee arrangement in a subsequent taxation year, regardless of whether the professional has a legal right to collect such fees at the end of the year.

While professionals who utilize contingent fee arrangements would not typically have a legal right to receive some or all of their fee until the occurrence of the specified contingent event, it may not be

reasonable to expect that they would not receive some fee payment in respect of the arrangement in a future taxation year.

Moreover, it is also unclear whether this reasonable expectation test should be applied on a global basis to all of the fee arrangements the professional has entered into or whether it should be applied in respect of each individual arrangement. It may be especially difficult to conclude that a professional who engages in a large number of contingent fee arrangements does not have a reasonable expectation of receiving some amount in the future in respect of their entire portfolio of contingent fee arrangements outstanding at the end of a particular taxation year.

Notwithstanding the CRA's helpful comments, in the interest of certainty, we recommend that the proposed changes be supported with an amendment to the Act that clearly specifies that the value of WIP that relates to appropriately documented contingent fee arrangements in which the professional's legal entitlement to a fee is dependent on one or more specified contingent events that have not yet occurred would be nil for the purposes of subsection 10(1). In this regard, any supporting documentation required to be provided should be framed with regard to the fact that an engagement letter between a lawyer and his or her client may be subject of solicitor-client privilege and accordingly a lawyer may not be able to share the letter with the CRA without the client's consent.

Appendix - Accounting for Work in Progress

For internal accounting purposes, most accounting and law partnerships will use one of three methods for income and draw determination purposes (we are assuming the same method will be used for both in this commentary):

1. WIP recorded at fair market value (FMV) – In this case, the partnership will add the FMV of unbilled WIP at year-end to their revenue for accounting and draw purposes. No adjustment is made to expenses.
2. WIP recorded at lower of cost and FMV – This is the method that would apply under generally accepted accounting principles. In this case, the cost of the WIP at year-end (or FMV if lower) reduces the expenses recorded on the income statement and is booked to the balance sheet as an asset. Revenue is recognized as billed. This is the method proposed in the **B**udget for tax purposes.
3. Billed Basis with no WIP adjustment – In this case, revenue is recognized as billed and no adjustment is made to expenses for the cost of WIP at year-end. This is the method currently allowed for tax purposes if a section 34 election is made.

In practice, the two most common practices for accountants and lawyers (ignoring those that perform contingent work) are alternatives 1 and 3. We find that lower of cost and FMV generally is not used due to complexity. We discuss the general implications of the proposed changes on these alternatives below, starting with alternative 3. Note that we have assumed that the only difference between accounting income and taxable income is the timing difference, if any, related to WIP.

Impact for Billed Basis Method (Alternative 3)

In this case, the partnership uses a process to calculate net income on a billed basis without any recognition of year end WIP. As such, the method used for accounting is also acceptable for tax under current rules, so the partnership does not have to deal with timing differences related to WIP.

Under the proposed changes, such a firm will have to bring 50% of the cost of WIP into income in year 1 and 100% in year 2 (assuming the FMV is higher). Two possible outcomes are likely from an accounting perspective. First, the firm may not change its method for determining income for accounting and draw purposes. In such a case, it will have to decide how to allocate the higher income that will arise for tax purposes to partners. Alternatively, the firm may decide to move to accounting for WIP at the lower of cost and FMV for internal purposes (since they must determine these amounts for tax purposes). This will make tax compliance simpler as a timing difference related to WIP will not have to be dealt with and the partners' incomes/draws will be coordinated with the extra tax that will arise under the proposed changes. In either case, the impact of the Budget change would presumably apply on a *pro rata* basis relative to the accounting income of each partner (unless the partnership uses another method to allocate WIP).

The next step is to review the financial impact. If the partnership does not change its method of accounting, the partner will have to use personal funds or will have to borrow to pay the extra tax on the additional taxable income which has not been received. Assuming WIP does not decrease over time, this unfunded tax liability will not reverse itself until the partner retires and then only if this issue is recognized by the partnership. To ensure fairness to a retiring partner, the partnership agreement

should provide for a reduction of taxable income allocated to a partner in their final year to reverse the accumulated addition to taxable income. We expect most partnership agreements will need to be amended to effect this change, and determining and implementing the amendments appropriate in any particular circumstances may be both contentious and time consuming.

Where a partnership changes their method of accounting to recognize WIP at FMV or at the lower of cost and FMV, the partnership will presumably have to borrow to pay draws. This borrowing will be permanent unless the partnership raises more capital from partners. Consequently, the proposed change could result in partners or partnerships incurring additional debt.

Impact for Partnerships that Record WIP at FMV (Alternative 1)

The issues for these partnerships are more complex and will be more onerous for some partners. To our knowledge, very few partnerships that have booked WIP at FMV for accounting purposes would use this income amount for tax purposes. More commonly, these firms have made the section 34 election and exclude WIP when determining taxable income. Therefore, many of these firms have devised a mechanism to track the timing difference on a partner by partner basis so that the accumulated deferral is allocated to the partner when they retire or otherwise leave the firm.

If a firm is growing and the WIP balance increases annually, there is generally a “net deduction” that is available annually if the partnership provides a reconciliation of accounting income to taxable income to their partners. How this timing difference is allocated will have a significant impact on how the proposed changes will affect partners.

Since attributing a firm’s WIP balance to individual partners specifically is very difficult, if not impossible, many partnerships allocate the net deduction on a different basis.

One common approach is to allocate the net deduction *pro rata* to the profit they have determined for accounting purposes. The net deduction each year is equal to the partner’s share of the total of the actual increase in WIP for the year and the accumulated WIP of partners that have left the firm (since their accumulated deferral becomes available to other partners once allocated to retiring partners as an increase in calculating taxable income).

This issue is best illustrated with an example.

Partnership A has 15 partners who share income equally. It is also assumed that the firm was formed on January 1st of year 1. For its first year, the partnership had accounting income of $7,500,000 (income of $500,000 per partner with WIP included). The firm also had $750,000 of WIP at year end.

For tax purposes under current rules, the taxable income for year 1 will be $450,000 and each partner will have accumulated a tax deferral of $50,000 (i.e. their share of the difference between closing WIP of $750,000 and opening WIP of $0). Going forward, it is assumed that the WIP balance will increase by 5% per year. As each partner leaves, a new equal share partner is admitted.

If we look at the partnership in year 15, there will be only one original partner left, and that partner’s accumulated tax deferral (basically his or her share of WIP) will be approximately $197,000. If the initial WIP balance of $50,000 per partner had increased by 5% per year, his or her WIP balance would have been only approximately $99,000 by year 15. The difference of almost $100,000 is due to partner

turnover - as partners leave, their WIP balance is allocated to the remaining 15 partners. The departing partners have an income inclusion that eliminates the deferral balance. The calculations are contained in the table on the following page.

Although the impact of the Budget change will be to include the FMV or the lower of cost and FMV of WIP in income, it is assumed that most partnerships will allocate this inclusion based on their *pro rata* share of accumulated WIP at FMV. Therefore, some partners will face a much higher inclusion when compared with others.

The other complication at play here is that the partners have accumulated a tax deferral that will reverse but have already received the accounting income giving rise to the deferral. This will create a cash flow mismatch as they will receive no funds related to the income inclusion for tax purposes.

Although the deferral would have eventually reversed, there are two key concerns related to the Budget change. First, unlike retirement, the firm will not be returning their capital investment to them. If retiring, a partner will often have their capital returned at approximately the same time as the tax deferral related to WIP becomes taxable to them. Where the partner has not borrowed to invest in the firm, the capital repayment will provide additional funds that can be used to pay the extra tax. Secondly, we believe that it is fair to say that no one expected the section 34 election would be removed and partners have not planned for this event in advance.

Note that some firms that book WIP at FMV do not use an incremental approach to allocate the net deduction for tax purposes each year. Rather, a partner's share of WIP for the prior year is added back to income in the current year, and the partner will get a new deduction for the WIP at year-end (presumably based on current income). While in circumstances in which this method is followed, the tax deferral will be spread much more evenly among partners, a cash flow mismatch will remain.

Table – Calculation for Illustration Used in Appendix

Year	Firm WIP	Partner 1	Partner 2	Partner 3	Partner 4	Partner 5	Partner 6	Partner 7	Partner 8	Partner 9	Partner 10	Partner 11	Partner 12	Partner 13	Partner 14	Partner 15
1	750,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000
2	787,500	(50,000)	5,833	5,833	5,833	5,833	5,833	5,833	5,833	5,833	5,833	5,833	5,833	5,833	5,833	5,833
3	826,875		(55,833)	6,347	6,347	6,347	6,347	6,347	6,347	6,347	6,347	6,347	6,347	6,347	6,347	6,347
4	868,219			(62,181)	6,902	6,902	6,902	6,902	6,902	6,902	6,902	6,902	6,902	6,902	6,902	6,902
5	911,630				(69,082)	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500
6	957,211					(76,582)	8,144	8,144	8,144	8,144	8,144	8,144	8,144	8,144	8,144	8,144
7	1,005,072						(84,726)	8,839	8,839	8,839	8,839	8,839	8,839	8,839	8,839	8,839
8	1,055,325							(93,565)	9,588	9,588	9,588	9,588	9,588	9,588	9,588	9,588
9	1,108,092								(103,153)	10,395	10,395	10,395	10,395	10,395	10,395	10,395
10	1,163,496									(113,548)	11,263	11,263	11,263	11,263	11,263	11,263
11	1,221,671										(124,811)	12,199	12,199	12,199	12,199	12,199
12	1,282,755											(137,010)	13,206	13,206	13,206	13,206
13	1,346,892												(150,216)	14,290	14,290	14,290
14	1,414,237													(164,507)	15,457	15,457
15	1,484,949														(179,963)	16,712
Accumulated defer		-	-	-	-	-	-	-	-	-	-	-	-	-	-	196,675

STANDING COMMITTEE ON FINANCE, TRADE AND ECONOMIC AFFAIRS

Appearance of the

Canadian Bar Association

September 21, 1982

ITEMS FOR DISCUSSION

1. Work in progress -- Resolutions 3, 16 and 119(5).
2. Director's liability -- Resolution 115.
3. Confidentiality -- Resolution 117.
4. Transfer of RRSP funds upon marriage breakdown -- Resolution 91(9).
5. Small business deduction -- Resolutions 81 and 101.

LIBRARY AND ARCHIVES CANADA / BIBLIOTHEQUE ET ARCHIVES CANADA
This copy is provided for research purposes only. Responsibility regarding questions of copyright that may arise in the use of this document is assumed by the recipient.
Cette copie est fournie pour fins de recherche seulement. La récipiendaire assumera la responsabilité de régler toute question de droits d'auteur connexe à une utilisation subséquente de ce document.
TITLE/TITRE
RG 14 MG R SERIES/SÉRIE
ACCESSION 1990-91/119 VOL PAGE(S)
BOX/BOITE 97 REEL/BOBINE
FILE/DOSSIER Wallet 27; File "Income Tax Act/Canadian Bar Association"
DATE

Submission to the Standing Committee on Finance,
Trade and Economic Affairs
by
The Canadian Bar Association
on
the Proposals to Tax Work in Progress
of a Professional Business

The Canadian Bar Association, which represents over 30,000 lawyers in all parts of Canada, is strongly opposed to the proposal originally contained in the November 12, 1981 Budget and continued in the Notice of Ways and Means Motion of June 28, 1982 to require work in progress to be included in computing income for tax purposes from a professional business. It is the basic proposition of this submission that the proposed method of accrual accounting for work in progress is not appropriate for determining income from the practise of law.

Present Rule

One of the recommendations of the 1969 White Paper "Proposals for Tax Reform" was to require professionals to use the accrual basis for their accounts receivable and work in progress. The Standing Committee on Finance, Trade and Economic Affairs gave careful study to this White Paper proposal. In its Report of October 5, 1970 the Committee recommended that:

> "the accrual basis for professionals be adopted for receivables but not for inventory and work in process, with a transitional period and appropriate safeguards to ensure that the timing of billings is not open to abuse."

In arriving at its conclusions, the Committee noted that professionals were unable to obtain many of the tax

advantages available to businessmen and that work in progress of a professional business, by its nature, raised unique difficulties of measurement in terms of "cost" or "value".

The rule finally adopted as part of the tax reform in 1971 allowed professionals to elect to exclude work in progress when computing income. However, at the same time, the accrual basis of computing professional income was adopted for accounts receivable. This method included a requirement that income must include any amount for professional services in respect of which no account had been issued if there had been undue delay in rendering the account. This provision was intended to require professionals to interim bill and thus bring their work in progress into income at an earlier date. There was also a requirement that any progress billings or advance billings be included in income even though such billing may have been rendered in advance of the performance of the services.

Transitional provisions were adopted regarding accounts receivable at the end of 1971 to require the amount of such accounts to be brought into income over a number of years.

November 12, 1981 Notice of Ways and Means Motion

Resolution 27 of the November 12, 1981 Notice of Ways and Means Motion proposed that, in computing the income for fiscal periods ending after 1981 from a professional business, the work in progress relating to the business at the end of the period be included at the lesser of its cost and net realizable value.

The expressed reason for this change was that the present rule fails to match costs with revenues for tax purposes and results in a deferral of tax. It was suggested that work in progress is essentially the inventory of professionals and that this change will put professionals on the same basis as other businesses.

December 18, 1981 Statement

In a statement made on December 18, 1981, the Minister of Finance announced that the proposals contained in Resolution 27 would be phased in over a two-year period, with one-half of the year-end work in progress being included in income for the 1983 fiscal period and the balance in the 1984 fiscal period. In dealing with the valuation of work in progress he stated:

> "The cost of work in progress will not include fixed or indirect overheads, such as rental, secretarial and general office expenses. It will generally be restricted to those costs, such as the salaries paid to professional employees, that are expected to be recovered in future billings. No cost is required to be imputed to partners' or proprietors' time."

June 28, 1982 Notice of Ways and Means Motion

The detailed Notice of Ways and Means Motion tabled in the House of Commons on June 28, 1982 proposes to amend the Income Tax Act to deal with work in progress as follows:

1. Section 34 of the Income Tax Act will be repealed with respect to the 1983 and subsequent taxation years. Section 34 permitted professionals to exclude work in progress in computing their income

and permitted the "billed basis" of computing professional income.

2. The definition of property in subsection 248(1) will be amended to expressly include work in progress of a business that is a profession. Subesection 10(5) will be amended to provide, for greater certainty, that property that is work in progress of a business that is a profession is inventory. Subsection 10(4) will also be amended to provide specifically that the fair market value of property that is work in progress of a professional business means "the amount that can reasonably be expected to become receivable in respect thereof after the end of the year." These provisions are applicable to the 1983 and subsequent taxation years.

3. A transitional provision will be contained in subsection (6) of section 10. It provides that the amount of the cost of work in progress, and the amount of the fair market value thereof, at the end of the 1983 taxation year will be deemed to be one-half of the amount thereof as otherwise determined (if an election to exclude work in progress in computing income has been made in respect of the 1982 taxation year). Thus, as the opening work in progress inventory for the fiscal period ending in the 1983 taxation year will be nil for tax purposes, one-half of the closing work in

progress inventory for the 1983 fiscal period will be included in income for tax purposes for the 1983 taxation year and the other half will be included in computing income for the 1984 taxation year.

Under section 9 of the Act, income from a business is the profit therefrom for the year and profit is determined in accordance with ordinary accounting principles. Thus, if the amendments to the Act proposed in the June 28, 1982 Notice of Ways and Means Motion are implemented, income from a professional business will have to be computed on a full accrual basis. Subject to the transitional rules for 1983 and 1984, the difference between work in progress inventory at the opening of the fiscal year and work in progress inventory at the end of the fiscal year will be added to income from the business as well as amounts billed during the year.

Nature of Work in Progress of a Lawyer

The practice of law is not conducted in any uniform manner and there is a wide variety of practises. Generally, work in progress of a lawyer commences when the lawyer accepts instructions from a client to undertake a matter on behalf of the client. The "work" consists of the lawyer's personal effort in representing the client in order to fulfil his instructions and may, or may not, involve other persons such as employed lawyers, students and law clerks, and secretarial and clerical assistance, and may, or may not, involve the preparation of documents or other written material. The "work" is "in progress" until the task has

been completed and an account rendered to the client. It is only at that time that the lawyer becomes entitled to any fee and, even then, the account can usually be taxed before an officer of the court. The ability of a lawyer to charge a fee for services rendered frequently depends upon the lawyer's ability to successfully complete the task which he has undertaken. The client is not usually willing to pay for incomplete work. The fee which a lawyer charges his client is affected by many factors and does not necessarily bear any relation to the time spent by a lawyer or his employees on behalf of a client.

It is not appropriate to compare work in progress of a lawyer to the inventory of a manufacturer or a merchant or the work in progress of other service businesses. A lawyer does not earn something when he spends time on his client's affairs which is comparable to what the manufacturer earns when he processes goods for manufacture.

The work of a lawyer on a particular assignment cannot be sold to another lawyer. When one lawyer succeeds another part way through a matter, the new lawyer will not purchase the former lawyer's work in progress. Instead, the new lawyer must himself carry out all work which is involved in successfully carrying out the client's instructions. For example, if a title opinion is required, the new lawyer must carry out his own title search and render his own opinion. Further, lenders do not generally regard work in progress as an asset which can be used as security in arranging a bank loan.

In summary, work in progress of a lawyer is not an asset which can be transferred for value. Accordingly, it is not proper to compare work in progress of a lawyer with commercial inventory work in progress for which a third party could take the physicl goods which exist and, by adding to the incomplete state, bring the goods to a marketable product. The reality is that, until a fee can be billed to a client, the expenses incurred by a lawyer are his costs and they should be treated as such for income tax purposes in the year in which they are incurred.

Fairness

The supplementary information accompanying the November 12, 1981 Budget suggested that one of the objectives of the proposed change is to put professionals on the same basis as other businesses. It is not appropriate to single out work in progress as the sole distinction between professionals and other businesses. Professionals do not have the same opportunities under the Income Tax Act as other businessmen.

The Income Tax Act does not permit lawyers to claim the full small business deduction. Many lawyers are prohibited by provincial law from incorporating. Where lawyers are permitted to incorporate, the professional practice of a lawyer carried on by a corporation is not entitled to the full small business deduction. The use of administrative service corporations does little to redress the imbalance. Why should professionals and other small

businessmen who incorporate be taxed on a different basis than professionals who cannot incorporate?

Lawyers have limited opportunities for providing for their retirement and, in particular, are not able to establish registered pension plans. Accordingly, as small businessmen, they are not in a position to obtain equivalent treatment under the Income Tax Act as, for example, a small manufacturing or merchandising business.

Lawyers are not entitled to use the cash method of computing their income, as is the case with salaried employees.

It should also be recognized that the proposal to tax work in progress will be very uneven in its application. Professional firms with a larger proportion of employed professionals in relation to partners will be affected the most.

There should be a balance in the system so that, in the end, the tax treatment of all small businessmen is roughly equivalent. The perfect matching of expenses and revenues may be attractive in theory but the tax system must be flexible enough to reflect differences in the manner in which various businesses are carried on so that accommodation is made for these differences in determining the overall tax burden. The present system permitting professionals to exclude work in progress recognizes that professionals do not have the same opportunities as other small businessmen and achieves a rough balance. The new proposal would remove this balance.

Impact on Cash Flow

There is already an increasing gap between billed basis income for tax purposes and cash available for distribution to proprietors or partners. The proposal to tax work in progress by adding another paper profit to taxable income, will increase this difference. It will pose a particular problem for young lawyers starting out who usually have to develop considerable work in progress over an initial period before they build up any significant amount of accounts receivable. As indicated earlier, the work in progress of a lawyer cannot be transferred for value and is not generally recognized by lenders as having any collateral value for securing a loan.

There is no compensating factor for inflation in order to recognize the fact that work in progress is included in income in circumstances where the account will not be rendered until a future date and will not be collected until an even later date when inflation has rendered the cash receipt worth less than the amount which has had to be included in income for tax purposes. The 3% inventory allowance, as presently contained in the Income Tax Act, will not be available to a lawyer in respect of work in progress which he has had to include in income. Therefore, the lawyer is not in the same position as other small businessmen with tangible inventory who, through the inventory allowance, presently receive a rough compensating factor for inflation.

Record Keeping

The Department of Finance appears to hold the

view that the accounting systems of a relatively few large Canadian law firms are the norm for the profession. This is wrong. A relatively small proportion of lawyers in Canada presently record or docket on a daily basis the time spent working on a client's matter. This is probably related to the fact that a majority of lawyers in Canada practise in small firms. A demographic survey of lawyers in Canada prepared in 1979 for the Canadian Bar Association indicates that over 70% of the lawyers in the country practise in fir with 10 members or less. Further, relatively few law firms have accounting systems in place to deal with the measureme of work in progress. In an Economic Survey of Law Firms prepared in co-operation with the Canadian Bar Association 1980 only 10% of the firms surveyed gave responses that indicated some record of work in progress was maintained. the assumption that the responses to the survey were from among the better administered law firms, it is probable th less than 19% of all Canadian law firms are capable of reporting work in progress. The percentage is probably in the 5% to 10% range.

Even where accounting systems are in place to record docketed time and such records are maintained, thes systems record estimated billable amounts and are not designed to keep track of the cost of employed professiona time on particular matters. These systems will require change.

The proposal to tax work in progress will impos significant and costly record keeping burden upon

practitioners and, in particular, upon small firms. These additional costs will undoubtedly add to the cost of legal services to the consumer which is an undesirable result.

Partnership Arrangements

In many cases law firms do not allocate work in progress to the partners on a current basis and, thus, it is not clear who would be required to pay tax on work in progress if it is now required to be included in income for tax purposes. Many partnership arrangements would have to be renegotiated to provide for an allocation of work in progress and to deal with work in progress upon the admission or retirement of partners. Difficulties will arise where a taxpayer has included work in progress in income as a partner of a firm but subsequently leaves the firm and does not become entitled to receive any amount in respect of which he was previously taxed.

Government Revenues

The November 12, 1981 Budget Papers set forth the revenue impact of the Budget tax changes. The proposal to tax work in progress of professionals was estimated to increase revenues by $75 million in the 1983/84 fiscal year and by $10 million in subsequent fiscal years. The basis for these figures is not given and they do not reflect the subsequent decision to phase in the new rules in over the 1983 and 1984 taxation years.

The relatively small increase in government revenues does not appear to justify the proposed changes, particularly if the additional accounting burden and costs

which the proposal would entail are taken into account. These additional burdens and costs come at a time of general economic difficulties being faced by lawyers in Canada.

Valuation Problems

In computing income under the proposal to tax work in progress, subsection 10(1) of the Act will require property described in an inventory to be valued at its cost to the taxpayer or its fair market value, whichever is lower. Subsection 10(4) will define fair market value for these purposes to mean "the amount that can reasonably be expected to become receivable in respect thereof after the end of the year". Arriving at such a realizable value for work in progress will be a highly subjective process. Ultimately, it is only the judgment of the lawyer as to what can properly be billed that can determine realizable value. It is often very difficult to determine the amount that can be billed until the matter is near completion. In some instances, the lawyer is not entitled to any amount for services unless he achieves success. For example, in those provinces which permit contingency fees for lawyers, until the matter is successfully completed, the realizable value of the work in progress would have to be nil. Every file in a lawyer's practice will have to be examined at year end to determine "the amount that can reasonably be expected to become a receivable in respect thereof after the end of the year."

While an amendment will be made to provide a specific rule for determining the fair market value of work in progress at the end of a fiscal period, no amendment is

proposed to be made for determining the cost of such work in progress. The December 18, 1981 statement of the Minister of Finance indicated that the year end cost of work in progress would be restricted to the direct costs associated with the employment of salaried professional staff. This is an important omission. Discussions with the Department of Finance indicate that the detemination of cost will be an administrative interpretation that will not be part of the Act. In other words, it will be left to the Department of National Revenue to form its views as to the appropriate method for determining the cost of year end work in progress. Their views, as published in Intepretation Bulletin IT-473 dated March 17, 1981 on the subject of Inventory Valuation, indicate that the cost of work in progress should include a share of overhead expense.

Accordingly, if the proposal to tax work in progress is to be implemented on the basis outlined by the Minister of Finance, a provision must be included specifying that, for the purposes of subsection 10(1) of the Act, the cost of work in progress of a business that is a profession will include only the remuneration paid to employees who are professionals.

Even with a specific provision defining cost for purposes of the new rules, difficulties will be encountered in arriving at the appropriate cost. It will be necessary to develop and maintain records for each file which will isolate the salary cost of employed lawyers, students and law clerks associated with the file. At year end every file will have

to be reviewed to determine the appropriate cost of the work in progress on that file. If an employee spends considerable time on matters such as continuing education, client promotion and other unrecorded time, an excess amount of salary will end up being attributed to work in progress as a proportion of the total time of the employee. Further, if employees have received increases in salary over the period of the work in progress, it will be difficult to adjust for these increases in arriving at the appropriate cost figure.

Transitional Rule

Although the presently proposed rule to bring existing work in progress into income over two years is an improvement from the original proposal, it is still unsatisfactory. It fails to recognize that work in progress has built up over a number of years and that amounts that were deducted at a time when a professional may have been at a low marginal rate of tax will have to be included in income at a high marginal rate of tax. If the proposal to tax work in progress is to be adopted, the proper method to implement such a basic change in the method of taxation of professionals would be to bring into income in the first year the increase between the cost of work in progress at the commencement of the year and the cost at the end of the year. This method could be accomplished if the new rule was made to apply for fiscal years commencing in 1983 and then the appropriate calculation for the cost of work in progress at the commencement of that year would be made when preparing financial statements for the year just ended. While this

method would forego tax on work in progress in existence at the beginning of the new regime, this would appear to be an acceptable and reasonable cost of such a fundamental change.

Alternatively, a transitional rule similar to that adopted in 1971 for "1971 accounts receivable" could be adopted. For example, work in progress at the end of the 1982 fiscal year could be brought into income over a 10 year period. This rule would be similar to that used in 1971 for corporations with 1971 accounts receivable and would be fairer than the two-year proposal.

Conclusion

The entire question of requiring professionals to use the accrual basis for their accounts receivable and work in progress was thoroughly debated and carefully considered by the Standing Committee of Finance, Trade and Economic Affairs in 1969 and 1970. The problems and difficulties presented to professionals by this proposal were recognized at that time and a decision was made after a full discussion of the subject that professionals should not be required to include work in progress in computing income for tax purposes. Nothing has changed to require a review of that decision.

The present provisions of the Income Tax Act are adequate to ensure that work in progress is brought into income at the earliest time that it is realistic to tax income from the practise of a profession. Further, the present provisions accommodate for the fact that most professionals are not entitled to the full small business

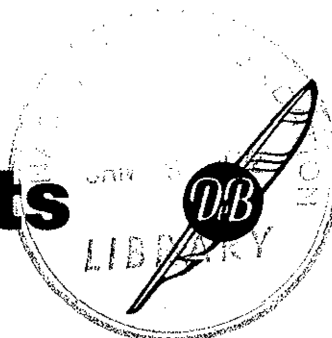
deduction or the full retirement planning opportunities available to incorporated small businesses and that professionals cannot use the cash basis which is available to salaried employees.

While theoretical tax policy may favour the measurement of business income on an accrual basis, tax policy in practise must accommodate the realities of the business world and the unusual position of professionals in that business world. It is respectfully submitted that all of the factors outlined in this submission lead to the conclusion that the proposal to include work in progress of a lawyer in income would not lead to total fairness or equity in the taxation of income from the practise of law.

The Canadian Bar Association is strongly of the opinion that the proposal to tax work in progress should be eliminated from the June 28, 1982 Ways and Means Motion.

September 17, 1982.

Budget Amendments 1981


LIBRARY

SPECIAL RELEASE

DECEMBER 28, 1981

© 1981, Richard De Boo Limited, 81 Curlew Drive, Don Mills, Ontario M3A 3P7

Notes on Transitional Arrangements and Amendments Relating to the November 12th, 1981 Federal Budget

Tabled in the House of Commons by
The Honourable Allan J. MacEachen, Minister of Finance

CONTENTS

Reserves 2
Capital Cost Allowances 2
Soft Costs 3
Work in Progress 4
Restricted Interest Expense 4
Retiring Allowances 6
Accrual of Interest Income 6
Income-Averaging Annuity Contracts 7
Small Business Bonds 7
Reorganizations 8
Loans to Non-Residents 9
Employer Housing Loans 9
Prescribed Rate of Interest 9
Deferred Profit-Sharing Plans 10
Life Insurance RRSPs 10
Life Insurance Policyholders 10
Contractual Commitments 11

Supplement to CTS Release No 361 — December 28, 1981.

RESERVES

Budget Resolution 31 proposed that for all dispositions of property after November 12, 1981 no reserve be permitted to a taxpayer in respect of the profit or capital gain attributable to unpaid instalments. The effect of this was that taxpayers could no longer defer income tax on profits or capital gains by arranging to receive the sale proceeds over a number of years.

Although the principle of this proposed measure is sound, there are a number of circumstances where the measure would impose some hardship and disrupt established business practices. It is therefore proposed that a reserve be provided over a maximum period of three years for dispositions of real property that give rise to ordinary income. for this purpose the proceeds will be treated first as a receipt of the profit. To the extent that the profit has not been reported in the year of sale and the subsequent year, it must be brought into income in the third year.

Modifications will also be made to ease the proposal in respect of taxable gains arising on dispositions of capital property. These taxable gains will also be brought into income as proceeds are received but a five-year reserve mechanism will be provided so as to ensure that the cumulative amount of taxable gain that has been brought into income is not less than one-fifth of the full taxable gain times the number of taxation years that have elapsed since the disposition. For example, where property is sold in 1982 for a taxable gain of $50,000, the maximum reserve that could be claimed in 1983 would be $30,000. The reserve would be less than $30,000 if by the end of 1983 the taxpayer had received proceeds of more than $20,000. The effect of the rules is to ensure that at least two-fifths of the taxable gain is included in income by the end of the second year.

The budget does not affect the existing rules allowing farmers and small business owners a tax-free rollover on the transfer of a farm property or shares to their children. However, some farmers choose to benefit from the general reserve provisions as an alternative to making a tax-free transfer. For transfers of a family farm by a taxpayer to his child, the five-year period for the reserve will be extended to 10 years. The same 10-year period for reserves will also apply to transfers of a family farm corporation or partnership or a small business corporation in the circumstances covered by the special rules pertaining to inter-generational transfers set out in subsections 73(3), (4) and (5) of the *Income Tax Act.*

The restrictions in the three, five and ten year periods over which reserves may be claimed will not apply where the property is disposed of pursuant to an agreement in writing entered into on or before November 12, 1981. The pre-budget rules will continue to apply to such transactions.

CAPITAL COST ALLOWANCES

The budget proposed that the capital cost allowance in the year an asset is acquired be limited to one-half the normal rate. The budget proposal in most cases applied to property acquired after November 12, 1981. It is desirable to allow an orderly transition to the new rules for taxpayers who were committed to acquire depreciable property before the budget. To achieve this it is proposed that assets acquired before the end of 1982 will continue to receive a full write-off rate in four circumstances. They are:

(a) where the taxpayer had made a binding written agreement before November 13, 1981 to acquire the property;

(b) where arrangements with respect to the acquisition or leasing of the property were substantially advanced and evidenced in writing before November 13, 1981, and where the taxpayer enters into a written obligation to acquire the property on or before May 31, 1982;

(c) where the taxpayer or a person with whom the taxpayer does not deal at arm's length had commenced the construction, manufacture or production of the property on or before the budget day; or

(d) where arrangements, evidenced in writing, for the construction, manufacture or production of the property were substantially advanced before November 13, 1981 and the construction, manufacture or production commences on or before May 31, 1982.

The half-year rule will apply to the amount by which the cost of any depreciable property of a prescribed class acquired by a taxpayer exceeds the proceeds of disposition of property of the same class in the year.

In addition, for depreciable property owned by a taxpayer before November 13, 1981, the half-year depreciation rule will not apply on its subsequent transfer to a related taxpayer. For depreciable property acquired after November 12, 1981, the half-year rule will not apply on a non-arm's length transfer provided the property had been owned by the transferor for at least 365 days or the property was not subject to the half-year rule on its acquisition. This rule is designed to accommodate most corporate reorganizations.

For those taxpayers who have a fiscal period commencing after 1981 that is less than 12 months, the amount of the capital cost allowance to which a taxpayer is otherwise entitled on each class of depreciable property will be required to be prorated on the basis of the number of days in the period.

Because of the long lead time required by producers of Canadian films to arrange interim financing and bring a film to the production stage, certain arrangements are entered into well in advance of production. In recognition of these arrangements which are peculiar to the film production industry, the half-year depreciation rule will be deferred until 1983 for investments in certified films. This transitional arrangement is in keeping with the government's policy of supporting a stable and viable Canadian film industry and ensures an orderly transition to the new rules which will become effective for film investments made in 1983.

SOFT COSTS

Budget Resolution 15 proposed that soft costs (other than landscaping) incurred after November 12, 1981 should be included in the cost of land and buildings rather than being immediately deductible. This applied both to multiple-unit residential buildings and to other real estate projects. There are a number of circumstances where extensive planning took place before November 12, 1981 for the construction of major building projects the financing of which was dependent on the existing tax treatment for soft costs.

It is proposed that soft costs will be deductible with respect to a building:

(a) the footings or other base support for which are in place by December 31, 1981, or

(b) where arrangements, evidenced in writing, for its construction in Canada were substantially advanced before November 13, 1981, and the footings or other base support are in place by May 31, 1982,

and provided in either case that construction proceeds without undue delay.

WORK IN PROGRESS

Budget Resolution 27 proposed that for fiscal periods ending after 1981, the work in progress of professional firms at the end of the period be included in computing income for that period. This proposal is to be phased in over a two-year period. As a result, it will not affect fiscal periods ending on or before December 31, 1982 and for the 1983 fiscal period only one-half of the year-end work in progress will be required to be included in professional income. The effect of the budget rule is that, after this transaction, costs of work in progress will not be tax-deductible until revenue from the work is included in income.

There has been some uncertainty concerning the valuation of work in progress for professionals. The cost of work in progress will not include fixed or indirect overheads, such as rental, secretarial and general office expenses. It will generally be restricted to those costs, such as the salaries paid to professional employees, that are expected to be recovered in future billings. No cost is required to be imputed to partners' or proprietors' time.

RESTRICTED INTEREST EXPENSE

Budget Resolution 23 proposed that for the 1982 and subsequent taxation years the interest expense that would otherwise be deductible in a year on money borrowed by an individual or partnership to earn income from property be restricted to such income for the year. The restriction did not apply where the funds were used in a business, to acquire an interest in a partnership carrying on an active business, or to acquire a residential rental building before November 13, 1981.

Transitional relief will be provided to give a period of time for taxpayers to reorganize their financial affairs in light of the new rules, but at the same time ensure that the basic purpose of the restricted interest expense rule is maintained.

Modifications to the rules relating to restricted interest expense are proposed to encourage investment in private small business corporations by investors and employees. In addition, for interest on funds borrowed to acquire shares of taxable Canadian corporations, including public corporations, a special deduction is provided for up to $10,000 of interest against non-investment income.

The $10,000 exception is designed to encourage equity investment by Canadians and to address the concern that the measure as proposed would bias equity investment towards those public shares that pay dividends and away from those companies whose earnings are retained in the business for expansion. The special rules for investment in the shares of private companies are described in the next paragraph. These are designed to facilitate investment in small business.

Private company equity investment

It is proposed that interest paid in a year will not fall within the restricted interest rules where it is in respect of loans used by an individual to acquire shares in a qualifying private corporation

(a) of which a taxpayer is a significant shareholder, or
(b) of which the taxpayer is an employee to the extent that such interest does not exceed his income, including any remuneration, from the corporation for the year.

For the purpose of this rule a significant shareholding of an *individual* in a corporation is one in which he owns shares representing 10 per cent or more of the value and voting rights of all shares. To qualify as a significant shareholding, a *corporate* shareholder will have to own shares representing 25 per cent of the value and voting rights of all shares.

In addition, a qualifying private corporation means a taxable Canadian private corporation substantially all of whose property consists of

(a) assets used in an active or non-qualifying business carried on by it, or

(b) shares or indebtedness of any other qualifying private corporation in which it had a significant shareholding.

In addition, a corporation will not qualify if at any time after November 12, 1981 it has privatized or has become a successor to a non-qualifying corporation. The circumstances in which a private corporation becomes a successor to another corporation include:

— amalgamation with the other corporation,

— winding-up of the other corporation at a time when the private corporation was a significant shareholder of the other corporation, and

— the acquisition by the private corporation of property of the other corporation as a result of which the other corporation becomes a significant shareholder of the private corporation.

The purpose of this rule is to ensure that the incentives for investment in a private corporation do not become an inducement for public corporations to become private.

Pre-Budget Loans

Budget Resolution 20 proposed to eliminate the deduction of interest on loans taken out after November 12, 1981 where the funds were used to contribute to a registered retirement savings plan (RRSP), a registered pension plan (RPP) or to acquire an income-averaging annuity contract (IAAC). However, the treatment with respect to interest incurred on pre-budget loans used for these purposes was not specifically dealt with in the original budget proposals. Many individuals have organized their affairs under the provisions of the present *Income Tax Act* on the basis that interest would be fully deductible. A number of such individuals will not have sufficient other investment income to offset or absorb the interest on such loans. To accommodate this problem and allow these taxpayers whose interests are affected sufficient time to reorganize their affairs, it is proposed to treat as income from property all income received after 1981 from an RRSP, RPP or IAAC to the extent of the amount of any restricted interest expense incurred by the taxpayer on an obligation entered into before the budget to invest in any such plan or annuity.

Pre-Budget Building Loans

The rules relating to restricted interest expense will not apply on funds borrowed before the budget to acquire a residential rental building or on funds borrowed after November 12, 1981 to finance the purchase of any such building after that date in circumstances where the acquisition was pursuant to an agreement in writing entered into on or before the budget date. It has also been announced that the restricted interest rule would be waived for interest on funds borrowed by the first purchaser of a multiple-unit residential building (MURB) or by the first purchaser of an interest in a MURB partnership.

For this purpose the first purchaser will generally be regarded to be the first person who owned and held the investment as capital property after November 12, 1981 provided that it was acquired by him from a person or partnership for whom the property was regarded as inventory and fully taxed on disposition. This first-purchaser test may be evidenced by a certificate or similar affidavit by the vendor to the effect that the property was regarded, for tax purposes, as inventory to him.

Transitional Rule

A two-year transition is to be provided for interest that falls into the category of restricted interest. For 1982, any restricted interest expense may be deductible from up to two-thirds of the amount of the taxpayer's income determined before any deduction of restricted interest. For 1983, one-third of income may be offset by restricted interest. This means that most taxpayers, other than those who had taken what might be regarded as excessive advantage of the interest deduction, will have two years to rearrange their affairs to avoid the restriction on the deductibility of interest expenses.

RETIRING ALLOWANCES

Budget Resolution 42 proposed that tax-free transfers of retiring allowances to a registered pension plan (RPP) or a registered retirement savings plan (RRSP) after November 12 be restricted to $3,500 for each year of employment during which the employee was not a member of an RPP or deferred profit-sharing plan (DPSP).

Tax-free transfers to RRSPs should also be permitted for employees who have been members of their employers' pension plans in situations where the employers' contributions to those plans have not vested as in the case of plant closings, or where pension entitlements need to be augmented. It is proposed that several changes be made to this proposal.

First, those employees who retired prior to November 13, 1981 will be allowed to transfer, tax free, to an RRSP the total amount of the retiring allowance received in respect of that retirement even if it is received after November 12, 1981.

Second, all employees who retire after November 12, 1981 and before 1982 will be allowed to transfer to an RRSP the full amount of a retiring allowance in respect of such retirement where the allowance was received pursuant to a written agreement to retire that was entered into on or before the budget date.

Third, a tax-free transfer of a retiring allowance will be allowed by a person who was a member of a registered pension plan or a deferred profit-sharing plan. Such transfer will be limited to $2,000 for each year during which he was employed by the employer who paid the allowance and was a member of the employer's RPP or DPSP. In addition, the budget proposal will be altered to allow the tax-free transfer to an RRSP of a retiring allowance in the amount of $3,500 for each year during which the employee was a member of an RPP or DPSP of his employer but in respect of which employer contributions to the plan did not vest in him.

ACCRUAL OF INTEREST INCOME

A modification is proposed to the change in Budget Resolutions 8, 9 and 10 concerning the reporting of accrued interest income on annuities

and other debt obligations. On such instruments acquired by individuals prior to the budget, only income attributed to the period following the first anniversary date after November 12, 1981 in the case of annuities — and after December 31, 1981 in the case of debt obligations — will be required to be included in income on the three-year accrual basis. Similarly where a corporation, partnership or trust acquired an annuity before December 20, 1980 or a debt obligation before October 28, 1980, only the income accrued in taxation years beginning after November 12, 1981 will be required to be included in income annually. This modification, which will not apply to financial institutions, should smooth the transition to the new rules for holders of existing financial instruments.

INCOME-AVERAGING ANNUITY CONTRACTS (IAACs)

Budget Resolution 43 proposed that amounts paid after November 12, 1981 to purchase an income-averaging annuity contract (IAAC) would be deductible only if all annuity payments under the contract are to be paid out before 1983.

Representations have been received from a number of individuals who had not technically purchased an IAAC before the budget date, but had arranged in writing to have the funds withheld from their remuneration for transfer into an IAAC. It is proposed that the budget changes on IAACs not apply in such cases where income had been earned and the funds had been withheld before November 12, 1981.

It is also proposed that all qualifying income may be contributed to a one-year annuity contract issued after budget day and not (as required under the present law) the qualifying income less an amount equal to one year's annuity payment. In addition, payments out of such a short-term annuity contract in 1982 will not be subject to deduction of tax at source.

SMALL BUSINESS BONDS

Under the small business bond provision, reduced interest rates for qualifying small business borrowers are made possible under a tax rule treating interest on the loan as a dividend and thus tax-exempt for corporate lenders. Budget Resolution 13 proposed that for small business bonds issued after November 12, 1981, only interest in excess of 6 per cent would be eligible for this tax exemption unless the bond was issued pursuant to an agreement in writing made on or before November 12, 1981. Budget Resolution 160 proposed a similar 6-per-cent threshold for term preferred shares, income bonds or debentures issued in cases of financial difficulty. It is proposed to remove the threshold requirement in all cases. This means that the entire amount of the interest paid on any qualifying small business bond issued after November 12, 1981 will qualify for the exemption, as the whole amount will be treated as a dividend. Similarly, the 6-per-cent threshold will be removed from term preferred shares and income bonds or debentures issued under conditions of financial difficulty.

It is also proposed to extend the deadline to January 31, 1982, for the issue of small business bonds by qualifying small business corporations and for the acquisition of specified property for business expansion.

A separate release providing details of the new rules proposed for small business bonds will be published shortly.

REORGANIZATIONS

The budget proposed that all transfers of property to corporations and all corporate share transfers, exchanges, amalgamations and other corporate reorganizations be treated as currently taxable dispositions except in those cases where the transferor controls the corporation to whom the property is transferred or where the reorganization does not result in any change in control of a corporation. There was also an exception for transfers of property by an individual to a small business corporation. The changes were proposed to be effective for transactions after November 12, 1981.

These proposals have affected the tax consequences of numerous reorganizations that were in process at the date of the budget. While this issue was addressed in a press release on November 18 with respect to reorganizations that were substantially concluded before the budget, the variety and complexity of the transactions in progress are such that uncertainty remains as to the scope of the transitional provisions. In addition, the control test set out in the budget measures may have the effect of imposing the tax on capital gains where shares are disposed of in the course of a reorganization leading to a business combination or pooling of interest. This type of reorganization is not unusual, particularly for smaller corporations wanting to join their business assets and operations.

To remove the uncertainty that would otherwise exist, to allow a reasonable period of transition for those reorganizations that are in progress and to provide additional time to consider modifications to the rules proposed in this complex area of the law, it is proposed that the existing reorganization rules in the *Income Tax Act* be maintained for transactions completed before the end of 1982. This will have the effect of postponing the effective date to January 1, 1983 for those changes to the *Income Tax Act* proposed in Budget Resolutions 33 (Tax-Free Dispositions); 56 (Transfers to a Corporation); 58 (Share for Share Exchange); 60 (Amalgamations); 64(a) and (b) (Foreign Affiliate Reorganizations) and 70 (Transfers to a Partnership).

A number of clarifications of general interest are also being provided with respect to various corporate measures.

The 12.5 per cent corporate distributions tax applies to dividends paid by corporations out of earnings that have enjoyed the benefits of the small business deduction. The tax is necessary in order to ensure that the small business tax matches the ultimate dividend tax credit. In determining whether a dividend is paid out of low-rate earnings, dividends will be considered to be distributed first from investment income, next out of low-rate earnings and then out of other business earnings. In addition, payments on arm's-length small business bonds will not be treated as dividends for purposes of this tax.

Budget Resolution 160(c) deals with after-tax financing and proposes that dividends received by any corporation on shares that are redeemable within five years from the date of issue will no longer be deductible. As indicated in the resolution, this rule will not apply to a dividend received on a "prescribed share". For this purpose, a prescribed share will include a publicly listed share as prescribed under income tax Regulation 6201 for the purpose of the definition "term preferred share". In addition, dividends received by a corporation on shares of a controlled subsidiary and dividends received as part of a transaction or series of transactions to which paragraph 55(3)(b) of the *Income Tax Act* applies will not be subject to this new rule.

Budget Resolution 24 extends the restricted interest expense rules to certain borrowings by corporations. This anti-avoidance rule is designed to apply to incorporated investment portfolios. As such, it will not apply to public corporations nor will it apply to borrowings to finance shares or indebtedness of subsidiary corporations.

LOANS TO NON-RESIDENTS

The existing *Income Tax Act* requires interest to be imputed on certain loans to non-residents. Budget Resolution 14 proposes, effective January 1, 1982, to extend the imputation requirement to other forms of indebtedness and to remove the exemption for loans by a corporation to its foreign subsidiary.

A number of Canadian corporations typically fund the overseas operations they carry on through their foreign subsidiaries by way of a combination of equity capital and interest-free debt. While it is clearly appropriate to require interest to be charged on funds loaned to a foreign subsidiary and, indeed, most other countries require interest to be charged on such loans, for a number of companies it will be unduly disruptive and in some cases impossible to reorganize their affairs before the end of the year when the new rules take effect.

It is therefore proposed that the changes proposed to section 17 not apply to require the imputation of interest for any period before January 1, 1983 except with respect to a loan made to a non-resident after November 12, 1981 by a corporation, partnership or trust. It will not apply to any such loan on which interest is payable at a reasonable rate.

EMPLOYER HOUSING LOANS

Budget Resolution 51 proposed that the existing $50,000 exclusion for low-interest employee housing loans was to be withdrawn effective January 1, 1982 and a taxable benefit be imputed to the employee at prescribed rates of interest applicable when the loan was made. It is proposed that this change be phased in for existing housing loans to allow employers time to work out new remuneration arrangements for their employees who are affected by this measure. Under this phase-in, no tax will be payable on the benefit to an employee from the first $40,000 of housing loan outstanding in 1982, and for the first $20,000 of such loans in 1983. Thereafter the special exclusion for housing loans will no longer apply. These transitional rules will apply only to loans for which arrangements in writing were concluded on or before November 12, 1981.

PRESCRIBED RATE OF INTEREST

The prescribed rate is the rate of interest charged on tax arrears and paid on tax refunds and is also the rate used to determine taxable benefits on interest-free loans to employees, shareholders and non-residents. The budget supplementary information indicated that starting in 1982 the prescribed rate of interest would be established quarterly on the basis of the average interest rate on 90-day treasury bills during the first month of the preceding quarter. It was noted that for the first quarter of 1982 the prescribed rate would therefore, be increased from the existing rate of 12 per cent to 19 per cent, based on October interest rates for treasury bills.

Interest rates have dropped significantly since the budget and the 90-day treasury bill rate for November was about 16 per cent. The prescribed

rate for the first quarter of 1982 will therefore be reduced to 16 per cent. The prescribed interest rate for subsequent quarters will be set in accordance with the formula outlined in the budget.

DEFERRED PROFIT-SHARING PLANS

Budget Resolutions 127 and 130 proposed to deny a deduction for any contribution to a deferred profit-sharing plan (DPSP) in which the owner or significant shareholder is a beneficiary, for taxation years commencing after November 12, 1981. It also proposed to restrict the contribution to a registered retirement savings plan (RRSP) to $3,500 for a year in which an individual was a member of a DPSP.

The budget proposal would require many companies to reorganize their existing deferred income plans for employees to ensure that the owners or principal shareholders and their relatives were excluded from a DPSP.

It is proposed that rather than deny a deduction for all contributions made to existing DPSPs in which the owner or principal shareholder is a beneficiary, the deduction should be disallowed only for those contributions for taxation years commencing after the budget date made on behalf of a beneficiary referred to in Budget Resolution 130. This includes certain shareholders and others who have a significant interest in the business. It is proposed also to limit the RRSP contribution to $3,500 in a year only if a contribution has been made to a DPSP either by a taxpayer in the year or on his behalf in the fiscal period of an employer that ends in the year. Registration will be denied for future DPSPs which allow an owner, specified shareholder or any related person to qualify as a beneficiary of the plan.

LIFE INSURANCE RRSPs

Budget Resolution 126 requires that where term life insurance or some other benefit has been used as an inducement for a person to enter into a registered retirement savings plan (RRSP), the plan will not qualify unless any such ancillary benefits are removed before July 1, 1982. This change was made to curtail the growing use of promotional schemes by financial institutions for selling RRSPs since the cost of such benefits would inevitably be borne by the beneficiary in the form of lower retirement income.

Representations have been received by a number of uninsurable individuals who have invested in RRSPs with this insurance feature and who will be unable to replace the coverage if it is cancelled. It is proposed that the life insurance coverage existing at December 31, 1981 not be required to be cancelled on any RRSP in effect on that date.

LIFE INSURANCE POLICYHOLDERS

Budget Resolution 134 proposed that the adjusted cost basis of a life insurance policy exclude that portion of any premium that is not reasonably attributable to the savings element of the policy. In response to concerns expressed by holders of existing policies, the application of the new rule will be confined to policies issued after November 12, 1981. Thus the adjusted cost basis of the policies in force before the budget will not be affected by the budget proposal. Technical discussisons will continue with life insurance industry representatives on appropriate taxation of the interest build-up in whole life insurance policies issued after the budget date.

CONTRACTUAL COMMITMENTS

The budget was silent in a number of areas on proposed new rules as they apply to transactions carried out pursuant to contracts and arrangements in writing made before the budget date. The normal practice of accommodating the tax treatment of a purchase or sale transaction concluded after the budget but pursuant to an agreement in writing entered into before the budget will be followed in implementing the changes proposed.

Thus, for example, the budget proposals in Resolutions 22 and 31 relating to terminal losses and reserves will not apply on a disposal by a taxpayer of property after November 12, 1981 pursuant to an agreement in writing concluded on or before that date. Similarly the proposals in Budget Resolutions 62 and 111, referring to the effect of asset disposals on the capital dividend and refundable dividend tax accounts, will not apply with respect to dispositions of property made under agreements in writing entered into on or before November 12, 1981. In addition, the proposals in Budget Resolutions 84 and 85 relating to the treatment of losses will not apply where the change of control is a consequence of a purchase of shares pursuant to an agreement in writing entered into on or before the budget date. These circumstances will be accommodated in the legislation introduced to implement the budget proposals.