

TAXTALK

NEW WIP RULES FOR PROFESSIONALS

Billed-Based Tax Accounting

Members of designated professions (accountants, dentists, lawyers, medical doctors, veterinarians, and chiropractors) may elect to exclude the value of their work in progress (WIP) in computing their income. Where this election is made, a tax deferral is achieved as the costs associated with the WIP are deducted as incurred whereas the revenue is recognized only when the WIP is actually billed to clients.

On March 21, 2017 and September 8, 2017 Finance introduced new rules to eliminate the ability for professionals to deduct WIP for future years beginning after March 21, 2017.

The new WIP rules will operate as follows for taxation years beginning after March 21, 2017 (in most instances the first year of impact will be the year ending December 31, 2018):

- 2018 tax year-end – 20% of the ending 2018 WIP value will be included in taxable income.
- 2019 tax year-end – 40% of the ending 2019 WIP value will be included in taxable income.
- 2020 tax year-end – 60% of the ending 2020 WIP value will be included in taxable income.
- 2021 tax year-end – 80% of the ending 2021 WIP value will be included in taxable income.

- 2022 tax year-end – 100% of the ending 2022 WIP value will be included in taxable income.

Relief is only available where the taxpayer elected to exclude WIP in computing income in the last taxation year that begins before March 22, 2017.

Originally, Finance had the WIP deduction being phased out over 2 years, but the extension of the transition period from 2 to 5 years provides professional firms with the opportunity to absorb the tax impact of these changes over a longer time horizon to better manage the cash outlay associated with any additional tax liability.

Impact of Revised WIP Rules on Future Taxable Income

The potential impact of these updated WIP rules are illustrated in *Exhibit A* of this TaxTalk. The three examples provided take into account the effect on taxable income for:

- (i) a partnership with no or nominal movement in its WIP balance in future years;
- (ii) a partnership with expected reductions to its WIP balance over time;
- (iii) a partnership with expected increases to its WIP balance over time.

Valuing WIP

These provisions will require a determination of the cost of the WIP, which may not be readily available.

Concerning contingency fee arrangements, CRA clarified after the 2017 Federal Budget that WIP in respect of bona fide contingency fee arrangements would not be required to be recognized into income. Accordingly, the CRA has indicated that the above WIP rule changes will not impact contingency fee arrangements.

CRA also clarified that any expenses incurred with respect to such contingency fee arrangements will continue to be deductible for the period in which they are incurred providing that the client has no obligation to the professional in respect of the expenses until some successful future outcome is obtained.

Conclusion

It's reasonable to conclude that a write-down of WIP in the next five years will have the effect of lowering net income for accounting purposes, which in turn, will lower taxable income of the business. This is a good result, but a write-down of WIP could also lower the professionals' income allocation. In any event, the write-down of WIP should be reviewed on a yearly basis to determine if any adjustments are necessary.

If you want to learn more about the WIP rules for professionals and the impact it will have on you and your practice please contact us to discuss further.

A memorandum of this nature cannot be all-encompassing and is not intended to replace professional advice. Its purpose is to highlight tax planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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Exhibit A

Impact to Taxable Income Due to New 5 Year WIP Adjustment Rule

WIP Example #1 - stable WIP balance

Tax Year		2017	2018	2019	2020	2021	2022	2023
Opening WIP balance	A	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Closing WIP balance	B	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Net income (not including current year WIP adj'ts)	C	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000
Accounting income [C + (B - A)]		1,500,000	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000
Prior year S 34(a) deduction	+	1,000,000	1,000,000					
Current year S 34(a) deduction	-	(1,000,000)						
New - S 10(14.1) adjustment [over 5 yrs]	-		(800,000)	(600,000)	(400,000)	(200,000)	-	-
Prior year S 10(14.1) adjustment (S 12(1)(b))	+			800,000	600,000	400,000	200,000	-
Taxable income allocated to partners		1,500,000	1,700,000	1,700,000	1,700,000	1,700,000	1,700,000	1,500,000
<i>Additional income inclusion due to new WIP rules</i>		-	200,000	200,000	200,000	200,000	200,000	-

WIP Example #2 - reduction of WIP balance

Tax Year		2017	2018	2019	2020	2021	2022	2023
Opening WIP balance	A	1,000,000	1,000,000	800,000	800,000	600,000	600,000	500,000
Closing WIP balance	B	1,000,000	800,000	800,000	600,000	600,000	500,000	500,000
Net income (not including current year WIP adj'ts)	C	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000
Accounting income [C + (B - A)]		1,500,000	1,300,000	1,500,000	1,300,000	1,500,000	1,400,000	1,500,000
Prior year S 34(a) deduction	+	1,000,000	1,000,000					
Current year S 34(a) deduction	-	(1,000,000)						
New - S 10(14.1) adjustment [over 5 yrs]	-		(640,000)	(480,000)	(240,000)	(120,000)	-	-
Prior year S 10(14.1) adjustment (S 12(1)(b))	+			640,000	480,000	240,000	120,000	-
Taxable income allocated to partners		1,500,000	1,660,000	1,660,000	1,540,000	1,620,000	1,520,000	1,500,000
<i>Additional income inclusion due to new WIP rules</i>		-	360,000	160,000	240,000	120,000	120,000	-

WIP Example #3 - increase of WIP

Tax Year		2017	2018	2019	2020	2021	2022	2023
Opening WIP balance	A	1,000,000	1,000,000	1,200,000	1,200,000	1,400,000	1,400,000	1,500,000
Closing WIP balance	B	1,000,000	1,200,000	1,200,000	1,400,000	1,400,000	1,500,000	1,500,000
Net income (not including current year WIP adj'ts)	C	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000
Accounting income [C + (B - A)]		1,500,000	1,700,000	1,500,000	1,700,000	1,500,000	1,600,000	1,500,000
Prior year S 34(a) deduction	+	1,000,000	1,000,000					
Current year S 34(a) deduction	-	(1,000,000)						
New - S 10(14.1) adjustment [over 5 yrs]	-		(960,000)	(720,000)	(560,000)	(280,000)	-	-
Prior year S 10(14.1) adjustment (S 12(1)(b))	+			960,000	720,000	560,000	280,000	-
Taxable income allocated to partners		1,500,000	1,740,000	1,740,000	1,860,000	1,780,000	1,880,000	1,500,000
<i>Additional income inclusion due to new WIP rules</i>		-	40,000	240,000	160,000	280,000	280,000	-