Whip that WIP: Canada's proposed tax repeal of a professional's WIP exclusion election

Kenneth Keung CA, CPA (CO, USA), CFP, LLB, MTAX, TEP and Kim G C Moody FCA, TEP
March 28, 2017

Earlier this week, we provided our summary of the 2017 federal budget released on March 22, 2017. The Budget contained a little-publicized but important tax change for how Canadian professionals will report their taxable income going forward. Effective for taxation years beginning after March 21, 2017, every professional must include its year-end work-in-progress (WIP) in its taxable income. For professionals, WIP generally represents unbilled time and supplies incurred in the rendering of services to clients. This blog will attempt to explain the current rules governing the recording of WIP and the history behind these rules, illustrate the impact of the proposed measures, and the practical challenges professionals will face. We will also provide a few tax policy comments to close.

History of Section 34 and Subsection 10(5)

Today, the rules governing WIP for professionals are contained in sections 10 and 34 of the *Canadian Income Tax Act* (*the Act*). To understand the original legislative intent of these provisions, it is useful to go back in history to the Carter Commission's *Report of the Royal Commission on Taxation* in 1966. The Carter Commission was tasked with examining and recommending improvements to the entire Canadian tax system, and one of the areas examined was the timing of revenue recognition. At that time, a taxpayer engaged in a profession was specifically permitted to elect to use the "cash basis" method of accounting, where amounts would be included in income only when cash was received and amounts would be deducted only when cash was disbursed. The Carter Commission did not believe this to be appropriate and advocated that accrual accounting become the law of the land for all Canadian taxpayers (including professionals) with very limited exceptions.

The Carter Commission Report became the catalyst of a number of key tax changes introduced in 1972. The government, however, backed away from wholeheartedly adopting a full accrual method for professionals. In 1971, Honourable E.J. Benson, Minister of Finance, released amendments to *the Act* and a *Summary of 1971 Tax Reform Legislation (*the *Summary*). In it, the *Summary* agreed with the Carter Commission that taxpayers in the professions should no longer be entitled to use "cash basis" accounting. However, the *Summary* recognized that "*because of the difficulty in valuing unbilled time, the legislation provides that work in progress need not be brought into income unless the taxpayer chooses to do so*." As a result, the 1972 tax reform package of legislation included section 34 allowing any "*business that is a profession*" an election to exclude year-end WIP from income.

Over the next decade, the government became significantly concerned about businesses claiming to be a "profession" and obtaining the benefit of the WIP exclusion election in section 34. For example, in the 1979 Tax Review Board case of *Tremblay v MNR*, the Board held that a public relations business was a "profession" because that term could encompass any businesses that require special qualification derived from training and experience. The government, concerned that businesses were taking undue advantage of section 34 to defer revenues while deducting the related expenses in the year incurred, enacted subsection 10(5) in 1982 to require all professional's year-end WIP be included in inventory, and by extension, income. However, at the same time, the government continued to recognize the very real challenges of properly valuing WIP for the traditional professions. Therefore, at the same time, section 34 was amended to allow accountants, dentists, lawyers, medical doctors, veterinarians, and chiropractors to be exempted from the impact of subsection 10(5).

Current Rules

Although some amendments have been introduced since the legislation was first introduced, the provisions of *the Act* today still reflects the underlying principles envisioned in those historical reforms.

Subsection 10(5) of *the Act* mandates that the "parts or supplies or *work in progress of a business that is a profession*" must be included in 'inventory'. This overrides accounting principles (and section 9 of *the Act* which includes the "profit" from a business in the taxpayer's income), which, without subsection 10(5), may or may not arrive at the same determination depending on the circumstances. The valuation of inventory is then governed by subsection 10(1) and section 1801 of the Income Tax Regulations (ITR), which requires one of two methodologies: i) lower of cost or fair market value (FMV), or ii) simply at FMV, which for a professional's WIP is deemed by paragraph 10(4)(a) of *the Act* to be the amount reasonably expected to become receivable after the end of the year.

On the other hand, paragraph 34(a) of *the Act* enables specific professions (accountant, dentist, lawyer, medical doctor, veterinarian, and chiropractor) to elect to exclude their year-end WIP from income.

As a result, many professionals elect to initially include WIP in their income pursuant to the rules in section 10, then claim an offsetting deduction under paragraph 34(a). Some professionals, particularly smaller practices, omit the recording of WIP from their accounting ledgers altogether, relying on paragraph 34(a) to arrive at the correct net tax result even though such reporting and disclosures are technically incorrect.

Proposed amendment

Despite paragraph 34(a)'s purpose and history of acting as a mirror "relief" provision to subsection 10(5), the Budget has proposed to abolish paragraph 34(a) for any taxation years that begin after March 21, 2017. To ease the transition in the year of the abolishment, proposed subsection 10(14.1) will deem the cost and FMV of the year-end WIP of that year to be one-half of the amounts otherwise determined.

Below is a numerical example to illustrate this. Apple Accounting (AA) has a December 31 taxation year-end (TYE), and it earns $10,000,000 of profits during each of its 2017, 2018 and 2019 TYEs. As part of its accounting practice, AA always includes in its income the WIP at the end of the year, valued at FMV in accordance with ITR 1801. The amount of WIP at the end of each of the 2016, 2017, 2018 and 2019 TYEs was $600,000, $700,000, $800,000 and $900,000 respectively. Where possible, AA takes advantage of paragraph 34(a) to claim an offsetting deduction against the amount of WIP included.

As a result of the proposed measures, AA's computation of taxable income will be as follows:

	For twelve months ended		
	Dec 31, 2017	Dec 31, 2018	Dec 31, 2019
Accounting / section 9 income	$10,000,000	$10,000,000	$10,000,000
Prior year s.34(a) deduction	$600,000	$700,000	N/A
Current year s.34(a)	($700,000)	N/A	N/A

deduction			
S.10(14.1) adjustment	N/A	(400,000)	N/A
S.12(1)(b) inclusion	N/A	N/A	$400,000
Taxable income	**$9,900,000**	**$10,300,000**	**$10,400,000**

AA's 2017 TYE is not affected by the proposed rules because 2017 TYE began before March 22, 2017. For 2018, paragraph 34(a) would no longer be available and ending WIP must be included in income. However, proposed subsection 10(14.1) would provide that at the end of 2018 TYE, the cost and FMV of the WIP is deemed to be halved. Assuming AA continues to value WIP at FMV in accordance with ITR 1801, the amount of 2018 WIP included in income would be $400,000 (i.e. $800,000 x 50%). Since $800,000 of year-end WIP has been included in the 2018 accounting/section 9 income, $400,000 needs to be subtracted.

For AA's 2019 TYE, neither paragraph 34(a) nor subsection 10(14.1) will apply. There is also no adjustment required regarding the ending WIP of $900,000 which is already part of accounting net income. However, as AA invoices its clients in 2019 for the 2018 ending WIP, AA would be required by paragraph 12(1)(b) to add to its 2019 income the amount not already included in its 2018 taxable income, i.e. the $400,000 adjustment.

The overall net result is that the $700,000 of 2017 year-end WIP is added to taxable income over AA's 2018 and 2019 TYEs, and all ending WIP is effectively included in taxable income for its 2019 TYE and subsequent years. For professional practices that historically have not converted WIP into receivables quickly, there will be even more incentive to convert quickly since the resulting cash can help pay the accelerated tax liability.

Practical and Planning Considerations

There will be a number of practical challenges for professionals to comply with the proposed amendments. One of the largest practical problems goes back to the premise of the original and amended section 34: it is often difficult for accountants, dentists, lawyers, medical doctors, veterinarians, and chiropractors to correctly determine the FMV of their WIP. As mentioned earlier, a professional's WIP is deemed by paragraph 10(4)(a) to be the amount reasonably expected to become receivable after the end of the year. However, for professionals who work on complex engagements like ourselves, figuring out how much of the WIP is ultimately recoverable is often guess-work. If the professional makes the wrong determination and over-estimates what is recoverable, it will result in an overstatement of taxable income for the year. The correction would not occur until the subsequent year as a bad debt expense under paragraphs 20(1)(l) or (p) of *the Act*.

For professional firms who never included year-end WIP in their accounting system or did not even keep track of WIP, complying with these new requirements will be even more challenging.

The above illustration assumes that the professional would continue to rely on ITR 1801 to value WIP at FMV, but this does not necessarily have to be the case. Subsection 10(1) allows taxpayers the alternative method of valuing inventory at the lower of cost or FMV. Presumably, the "cost" of producing WIP will always be lower than the amounts billable and recoverable from clients – otherwise, there would be no profit margin. Therefore, by choosing this alternative method, a professional should be able to reduce the amount of WIP it needs to include in its taxable income going forward under the proposed rules. However, the practical challenge of taking this position is how to determine "cost"? Can "cost" be salaries only? If overhead needs to be included, how much? Is there a cost element to "partners" who are not paid salaries but instead simply receive their share of partnership income? Supportable positions will need to be determined. This will not be easy.

Evaluating the proposed amendment from a tax policy perspective

It is often repeated that tax law should strive to be neutral, fair and equitable so that different taxpayers or businesses earning the same amount of income should be taxed similarly. It may appear that the repeal of section 34 is aligned with those goals because the repeal prevents professionals from excluding unbilled revenues from the calculation of their taxable income while claiming all expenses that were incurred in the year. However, section 34 of *the Act* was always meant to accompany subsection 10(5). Parliament only enacted subsection 10(5) in 1982 to create a default rule for all professionals to recognize WIP as inventory (rather than allowing for accounting principles to make that determination) because they were simultaneously amending section 34 to create an exemption for the traditional professions.

Without subsection 10(5), would professionals have to account for WIP in inventory and by extension, income, under generally accepted accounting principles/section 9? To answer this question, let's think about Bob the Painter. Bob provides painting service to clients, and at the end of the fiscal year, Bob has an unfinished project. Under generally accepted accounting principles/section 9, would Bob be required to include the cost or retail value of his WIP relating to this unfinished project in income for the year? Perhaps, but likely not. Is that so different from some of the work performed by professionals, particularly in respect of complex engagements or engagements where the ultimate results are uncertain? By retaining subsection 10(5), a provision that overrides accounting principles/section 9 and in some cases economic substance, while eliminating paragraph 34(a), the proposed measures put professionals at an unfair disadvantage compared to other businesses.

If the proposed repeal of paragraph 34(a) goes ahead, we submit that the Department of Finance should simultaneously remove the reference to "*work in progress of a business that is a profession*" from subsection 10(5). Doing so would rectify the distortion we describe above and allow for an economic substance to dictate the proper tax treatment of WIP for all taxpayers.

The repeal of paragraph 34(a) is, unfortunately, consistent with the recent trend of tax legislation against professionals in recent years – with the last major attack being the 2016 overhaul of the small business deduction rules. The government also announced in Budget 2017 that they are now studying ways to "shut down" common remuneration planning for private corporations and its shareholders. Whatever is coming will likely impact most professional businesses thus continuing the trend.

The following lyrics by the late 1970's and 1980's American new wave band, Devo, with their hit "Whip It" describes the proposed amendments for WIP aptly:

Now whip it
Into shape
Shape it up
Get straight
Go forward
Move ahead
Try to detect it
It's not too late
To whip it
Into shape
Shape it up
Get straight
Go forward

Move ahead
Try to detect it
It's not too late
To whip it
Whip it good

Professionals… whip that WIP good!