

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.

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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. Subsection 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 physical 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 firms with 10 members or less. Further, relatively few law firms have accounting systems in place to deal with the measurement of work in progress. In an Economic Survey of Law Firms prepared in co-operation with the Canadian Bar Association in 1980 only 10% of the firms surveyed gave responses that indicated some record of work in progress was maintained. On the assumption that the responses to the survey were from among the better administered law firms, it is probable that 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, these systems record estimated billable amounts and are not designed to keep track of the cost of employed professional time on particular matters. These systems will require change.

The proposal to tax work in progress will impose a 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 determination 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 Interpretation 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.