

Tax

New tax rules for lawyers: Value work-in-progress

By **David Rotfleisch**



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(April 27, 2018, 8:41 AM EDT) -- With the annual tax filing deadline on April 30, it is important to realize that the 2017 federal budget introduced a significant taxation change for professionals, including lawyers. This change now affects how non-employee lawyers are required to compute and report their income and requires that an extensive valuation of work-in-progress (WIP) takes place.

Canadian taxpayers must generally include the value of WIP in computing their income for tax purposes. However, prior to the 2017 budget, certain professionals such as lawyers or notaries (but accountants and other professionals as well), were able to elect to exclude the value of their unbilled work in progress in computing their income.

This allowed for professionals who complete work over months or years to defer taxation on the associated income until such time as the work was completed and invoiced. This WIP deferral allowed lawyers to better match the recognition and payment of tax with the cash receipts based on actual billings for a particular taxation year.

WIP for lawyers is essentially unbilled professional time and cost incurred in the provision of services to clients. WIP is typically tracked in the form of a lawyer's hourly charge-out rate, which represents the cost, overhead and some profit element.

The 2017 budget has eliminated the ability to elect to use billed-basis accounting (WIP deferral) as of taxation years that begin on or after March 22, 2017.

Draft legislation released Sept. 8, 2017, now provides for a five-year phase-in period for these new rules, instead of the two years originally proposed in the budget.

On April 28, 2017, the CRA indicated on its website that WIP in respect of a *bona fide* legal contingency fee arrangement would not be required to be included in income. CRA has also clarified that any expenses incurred with respect to such contingency fee engagements will continue to be deductible for the period in which they are incurred, provided that the client has no obligation to the lawyer in respect of the expenses until some successful future outcome is achieved.

What do these new rules mean for non-contingency retainers?

Lawyers should no longer record their WIP at their standard charge-out rates (if they recorded it at all) for tax purposes. (If they do so they will artificially increase their taxable income). Rather, they should record their work in progress at the lower of cost and net realizable value.

So, to take into account these new rules, lawyers will have to carry out a valuation of the actual cost of providing their legal services. This is a technical and complicated valuation in order to determine all of the cost elements that go into the services rendered.

Cost elements that have to be accounted for include wages and contractor fees and a reasonable allocation of overhead costs. Beyond that, the time spent by the partners of a legal firm are not clearly included since there is no cost of providing a service by a partner who is, of course, entitled to the net residual profits.

Furthermore, the allocation of overhead expenses related to providing partner services is unclear as well. A professional valuator may have to be retained in order to carry out these calculations.

In most cases, legal firms have to carry out this valuation to enable the income inclusion to be reported by their lawyer members by the tax filing deadline of June 15, 2019, (next year) since the new rules are effective for tax year-ends commencing after March 2017. However, now is a good time to speak to your accountant about the need for a valuation and the effect that these new rules will have on your 2018 income.

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