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

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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:

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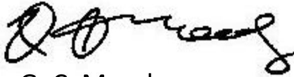
We trust that you will find our comments helpful and would be pleased to discuss them further at your convenience.

Yours very truly,



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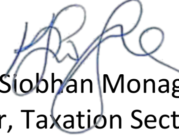

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Federal Budget 2017 - Proposed Amendments to Taxation of Work in Progress ("WIP") for Professionals
Joint Committee on Taxation Submission
May 31, 2017

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