The Advocates' Society

July 19, 2017

VIA EMAIL

The Honourable Jody Wilson-Raybould, P.C., M.P.
Minister of Justice and Attorney General of Canada
284 Wellington Street
Ottawa, ON
K1A 0H8

The Honourable Bill Morneau, P.C., M.P.
Minister of Finance
House of Commons
Ottawa, ON
K1A 0A6

Dear Ministers:

RE: Federal Budget 2017: Proposed elimination of the election by designated professionals to use billed-based accounting

I write this letter to supplement the letter of April 26, 2017 of my predecessor, Bradley Berg, on this topic. Since then, members of The Advocates' Society (the "Society") have had the opportunity to speak with Members of Parliament about the issues and consider our position in more detail.

As set out in our April 26 letter, attached, the proposed changes with regard to billed-based accounting could have a significant impact on litigation lawyers providing access to justice services to persons of limited financial means, including members of marginalized communities. Amongst all professionals affected by the proposed changes, the impact on litigation counsel is unique, as many consumers of their legal services can only obtain representation before the courts on a contingency or deferred fee arrangement.

The Society would like to focus its further comments on the proposed changes in three areas: the exception for *bona fide* contingency fee agreements, the need for clarity in any implementing legislation and the transition provisions.

1. Need for Clarity regarding the Exception for *bona fide* Contingency Fee Arrangements

The legislation should clearly state that *bona fide* contingency fee arrangements are exempt from its operation. The Society has noted the Frequently Asked Questions document released by the Ministry of Finance on April 28, 2017 (the "April 28 Release"), which provides the following information regarding contingency fee agreements:

> *5. How will the proposed change impact designated professionals that provide services on a contingency fee basis?*
>
> 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*.

This guidance is helpful – though it is not plainly obvious that it derives from the language contained in paragraph 10(4)(a) of the Act. If a carve-out for contingency fee arrangements is contemplated, the profession will require clarity as to the scope of that carve-out. In addition, if the carve-out is intended to be restricted to the types of arrangements described in the April 28 Release, the Society remains concerned that it may be too narrow. Litigation counsel have historically entered into a range of individualized contingency and deferred billing arrangements, tailored to their clients and practices. The contents of these agreements may contain obligations to pay fees on a purely contingent basis, on a deferred basis, on a hybrid basis, or success fees, depending on various triggering events in the contemplated litigation. The April 28 Release does not specify what, if any, of these other forms of agreement, would be included in the carve-out. As we noted in our April 26 letter, deferred billing cases are common in cases involving Aboriginal land claims, significant human rights issues, and family and labour and employment cases, among others.

2. Need for Legislative Precision in Other Respects

In addition, unlike billing arrangements of other professionals, agreements made between lawyers and their clients are subject to solicitor-client privilege and cannot be produced by a lawyer without his or her client's express or implied consent. The need to maintain privilege may pose unique evidentiary difficulties for lawyers seeking to substantiate that the "terms and

conditions of such arrangements are *bona fide*." This important issue should be addressed in the legislation or related guidance documents.

Finally, recognizing that many lawyers will elect under subsection 10(1) to use the cost method of valuing inventory, the Society is concerned that significant uncertainty persists regarding the meaning of the term "cost" as it applies to law practices, and in particular the question of how partners' time is to be accounted for. The profession will require guidance on this issue, whether in the legislation itself or ancillary interpretive aids, and a longer transition period would allow lawyers to make the necessary adjustments to their billing / accounting systems to ensure proper tracking.

3. Transitional Provisions

The Society is concerned that, given the significance of the proposed change and its impact on the legal profession, the proposed transition period of two years is too short. Many litigation firms have a significant historic inventory of WIP arising from contingency and deferred fee agreements made before the proposed changes were discussed, and these agreements cannot be altered. The inclusion of this inventory in income over a two year transition period exposes lawyers to significant tax liabilities, which in some cases they may not be able to finance. This will create undue hardship for the very cohort who have historically provided the most extensive and flexible fee arrangements to assist clients in obtaining access to justice.

If the proposal is to be implemented, the Society proposes a transition period of ten years to allow lawyers to better plan for and finance the tax liability arising from their historic arrangements. The Society also asks your Government to consider a *de minimis* exception to protect small or solo practitioners, and additional education and resources to assist with the transition and implementation.

In this regard, I would be grateful for the opportunity to discuss the matters raised in this letter in more detail with you.

I look forward to hearing from you.

Yours truly,

Sonia Bjorkquist

Sonia Bjorkquist
President

c. The Honourable François-Philippe Champagne, P.C., M.P.
The Honourable Kent Hehr, P.C., M.P.
The Honourable Ahmed Hussen, P.C., M.P.
The Honourable Mélanie Joly, P.C., M.P.
The Honourable Dominic LeBlanc, P.C., M.P.
The Honourable John McKay, P.C., M.P.
The Honourable Catherine McKenna, P.C., M.P.
The Honourable Denis Paradis, P.C., M.P.

The Honourable Ginette Petitpas Taylor, P.C., M.P.
The Honourable Carla Qualtrough, P.C., M.P.
The Honourable Geoff Regan, P.C., M.P.
William Amos, M.P.
Gary Anandasangaree, M.P.
René Arseneault, M.P.
Chris Bittle, M.P.
Sean Casey, M.P.
Arnold Chan, M.P.
Julie Dabrusin, M.P.
Anju Dhillon, M.P.
Nicola Di Iorio, M.P.
Ali Ehsassi, M.P.
Nathaniel Erskine-Smith, M.P.
Colin Fraser, M.P.
Sean Fraser, M.P.
Raj Grewal, M.P.
Anthony Housefather, M.P.
Angelo Iacono, M.P.
Iqra Khalid, M.P.
David Lametti, M.P.
Paul Lefebvre, M.P.
Joël Lightbound, M.P.
James Maloney, M.P.
David McGuinty, M.P.
Marco Mendicino, M.P.
Kyle Peterson, M.P.
Don Rusnak, M.P.
Ruby Sahota, M.P.
Ramesh Sangha, M.P.
Randeep Sarai, M.P.
Gagan Sikand, M.P.
Sven Spengemann, M.P.
Filomena Tassi, M.P.
Arif Virani, M.P.
Nick Whalen, M.P.

Members of The Advocates' Society Task Force

Megan E. Shortreed, Chair, *Paliare Roland Rosenberg Rothstein*, Toronto
Andrew Bernstein, *Torys LLP*, Toronto
Peter W. Kryworuk, *Lerners LLP*, London
Tara Sweeney, *Soloway, Wright LLP*, Ottawa
Adrienne Woodyard, *DLA Piper (Canada) LLP*, Toronto

April 26, 2017

VIA EMAIL

The Honourable Jody Wilson-Raybould, P.C., M.P.
Minister of Justice and Attorney General of Canada
284 Wellington Street
Ottawa, ON
K1A 0H8

The Honourable Bill Morneau, P.C., M.P.
Minister of Finance
House of Commons
Ottawa, ON
K1A 0A6

The Honourable Navdeep Bains, P.C., M.P.
Minister of Innovation, Science and Economic Development
House of Commons
Ottawa, ON
K1A 0A6

Dear Ministers:

RE: Federal Budget 2017: Proposed elimination of the election by designated professionals to use billed-based accounting

As you know, The Advocates' Society (the "Society"), founded in 1963, is a not-for-profit association of over 5,500 lawyers throughout Ontario and the rest of Canada. The mandate of the Society includes, among other things, making submissions to governments and other entities on matters that affect access to justice, the administration of justice and the practice of law by advocates.

The Society has reviewed the 2017 Federal Budget Plan with interest. The Society is concerned about the impact of one proposed change to the *Income Tax Act* (the "Act') which would have significant consequences on access to justice. This change, if implemented, could substantially reduce legal services available to certain groups and communities.

The current regime

Section 10 of the Act requires that inventory, including work in progress, be included in the computation of a taxpayer's annual income. This requirement is subject to an exemption under Section 34 of the Act whereby members of certain professions, including lawyers, may exclude

from the computation of their income an amount for unbilled work in progress. The relevant provisions are reproduced in Appendix A.

Section 34 was enacted to recognize that calculating income using an accrual-based method would pose a challenge for certain professions:

> Taxpayers in the professions (doctors, dentists, lawyers, chartered accountants, engineers etc.) have been permitted to compute their income on the "cash basis". This means that amounts are included in income only when cash is received and amounts are deducted only when cash is disbursed.
>
> [Section 34] requires that these taxpayers record income when fees are billed and expenses when they are incurred for fiscal years ending after December 31, 1971. 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.[1] [emphasis added]

The proposed change

The 2017 Federal Budget includes a proposal to eliminate the exemption in Section 34 of the Act (the "Proposal"). A description of the Proposal is reproduced in Appendix B.

The Proposal will have negative consequences for access to justice

The Society is concerned that low- and middle-income clients who enter into deferred or contingent billing arrangements for litigation services will be severely disadvantaged by the Proposal.

In areas such as family law, medical malpractice, personal injury, consumer protection, class actions, wills and estates, employment law and public interest litigation, members of the public often enter into deferred or contingent billing arrangements with their lawyers. These arrangements allow lawyers to provide services to those who do not have the means to pay for legal services up front or at the time the work is performed.

Deferred billing allows lawyers to carry large amounts of work in progress that are billed only on settlement or at the end of a trial. Some cases might take years to progress to a trial and exhaust all appeal routes. It is not unusual for a public interest case, such as an Aboriginal land claim or a significant human rights issue, to span more than a decade from its initiation to its conclusion. In the area of family law, for example, matrimonial law clients – particularly women – often use deferred billing arrangement because they first require an order of spousal or child support, or division of property before they can afford to pay legal fees. Deferred billing is also common in cases affecting the rights of unemployed workers to severance or damages for human rights claims or workplace injuries.

Contingency fees allow the public to retain a lawyer without having to pay legal fees unless the legal claim results in court-awarded damages or a financial settlement among the parties to a

[1] "Summary of 1971 Tax Reform Legislation", The Honourable E. J. Benson, Minister of Finance, at p. 51 (emphasis added).

dispute. One of the foundations of provincial class actions legislation is that class actions increase access to justice for injured parties who may not otherwise be able to initiate valid legal claims. Likewise, most personal injury and medical malpractice claims in Canada are litigated on the basis of contingent fees – and many of these cases involve severely injured or disabled plaintiffs.

Both deferred billing and contingency fee arrangements enhance access to justice, particularly for families, workers, the elderly, the disabled, consumers and members of marginalized communities.

Both types of arrangements also often result in high costs of unbilled work in progress. The Society has heard from its members that existing accumulated work in progress can be in the millions of dollars at firms that regularly engage in these types of arrangements. Lengthy delays in securing trial dates will extend the length of time for which a firm carries the tax burden related to work in progress.

If the Proposal is implemented and lawyers are required to include unbilled work in progress in their annual incomes, the resulting tax liability will be staggering for many lawyers, particularly in the transition years with respect to historically accrued work in progress. Many of the cases lawyers accept on a deferred or contingency fee basis are high-risk and the recorded value of work in progress does not equate with the actual fees which will be charged and recoverable.

The Society believes that the Proposal would create a significant disincentive and result in a major barrier to lawyers continuing to provide deferred or contingent legal services to those who need these services most. Certain groups and communities would see a significant reduction in the legal services available to them. Without access to experienced litigation counsel made possible by these billing arrangements, these citizens will simply not be able to afford redress through the justice system, and will rely more heavily on social programs. In this regard, the Society is concerned that the Proposal would not meet the standards of your Government's Gender-based Analysis and Gender-based Analysis Plus.

The Proposal ignores the difficulty of valuing the work in progress on high-risk litigation matters

It is notoriously difficult for a lawyer to ascertain the value of a particular claim in deferred billing and contingency fee arrangements, particularly given the high risks associated with litigation. The requirement for a lawyer to value the lesser of the cost and the fair market value of work in progress would result in financial uncertainty. This uncertainty, the Society believes, would create a further disincentive for lawyers to provide legal services under deferred billing and contingency fee arrangements.

The bar was not consulted on the Proposal

The Society is concerned that members of the bar were not consulted on this Proposal prior to its incorporation into the 2017 Federal Budget. Litigators in particular have a perspective and understanding of access to justice issues that affect their clients on a daily basis. As such, litigators are able to identify the potential unintended and long-term consequences of legislative changes.

In this regard, I would be grateful for the opportunity to discuss the matters raised in this letter in more detail with you.

I look forward to hearing from you.

Yours very truly,

Bradley E. Berg
President

c. The Honourable François-Philippe Champagne, P.C., M.P.
The Honourable Kent Hehr, P.C., M.P.
The Honourable Ahmed Hussen, P.C., M.P.
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James Maloney, M.P.
David McGuinty, M.P.
Marco Mendicino, M.P.

Kyle Peterson, M.P.
Don Rusnak, M.P.
Ruby Sahota, M.P.
Ramesh Sangha, M.P.
Randeep Sarai, M.P.
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Nick Whalen, M.P.

Members of The Advocates' Society Task Force

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Adrienne Woodyard, *DLA Piper (Canada) LLP*, Toronto

APPENDIX A
Income Tax Act, R.S.C., 1985, c. 1 (5th Supp.)
Excerpts: Sections 10(1), 10(5), 10(14) and 34

Valuation of inventory
10 (1) For the purpose of computing a taxpayer's income for a taxation year from a business that is not an adventure or concern in the nature of trade, property described in an inventory shall be valued at the end of the year at the cost at which the taxpayer acquired the property or its fair market value at the end of the year, whichever is lower, or in a prescribed manner.

[…]

Inventory
(5) Without restricting the generality of this section,

> **(a)** property (other than capital property) of a taxpayer that is advertising or packaging material, parts or supplies or work in progress of a business that is a profession is, for greater certainty, inventory of the taxpayer;

[…]

Work in progress
(14) For the purposes of subsections (12) and (13), property that is included in the inventory of a business includes property that would be so included if paragraph 34(a) did not apply.

Professional business
34 In computing the income of a taxpayer for a taxation year from a business that is the professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian or chiropractor, the following rules apply:

> **(a)** where the taxpayer so elects in the taxpayer's return of income under this Part for the year, there shall not be included any amount in respect of work in progress at the end of the year; and
> **(b)** where the taxpayer has made an election under this section, paragraph 34(a) shall apply in computing the taxpayer's income from the business for all subsequent taxation years unless the taxpayer, with the concurrence of the Minister and on such terms and conditions as are specified by the Minister, revokes the election to have that paragraph apply.

APPENDIX B
"Tax Measures: Supplementary Information", Tabled in the House of Commons by the Honourable William Francis Morneau, P.C., M.P., Minister of Finance, March 22, 2017
Excerpt: Page 27

BILLED-BASIS ACCOUNTING

Taxpayers are generally required to include the value of work in progress in computing their income for tax purposes. However, taxpayers in certain designated professions (i.e., accountants, dentists, lawyers, medical doctors, veterinarians and chiropractors) may elect to exclude the value of work in progress in computing their income. This election effectively allows income to be recognized when the work is billed (billed-basis accounting). Billed-basis accounting enables taxpayers to defer tax by permitting the costs associated with work in progress to be expensed without the matching inclusion of the associated revenues.

Budget 2017 proposes to eliminate the ability for designated professionals to elect to use billed-basis accounting.

This measure will apply to taxation years that begin on or after Budget Day.

To mitigate the effect on taxpayers, a transitional period will be provided to phase in the inclusion of work in progress into income. For the first taxation year that begins on or after Budget Day, 50 per cent of the lesser of the cost and the fair market value of work in progress will be taken into account for the purposes of determining the value of inventory held by the business under the *Income Tax Act*. For the second, and each successive, taxation year that begins on or after Budget Day, the full amount of the lesser of the cost and the fair market value of work in progress will be taken into account for the purposes of valuing inventory.