

natural desire of private enterprise is to emerge from the conflict in a sound financial position. Whether the realization of this desire is compatible with the effort necessary to defeat totalitarianism in a world-wide war is, to say the least, problematical.

## THE ADMINISTRATION OF THE TAX AND THE BOARD OF REFEREES

By COURTLAND ELLIOTT

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THE Board of Referees has a limited although important role in the administration of the Excess Profits Tax. The duties of deciding liability for tax, determining assessments, adjusting the base for capital changes and calendar year apportionments, and even authorizing eligibility for a reference to the Board rest with the Minister of National Revenue acting through the Income Tax Division. The Board deals only with establishing a base for calculating tax liability.

Unlike most types of taxation which can be levied upon some clearly ascertainable and immediate base, the Canadian excess profits tax relies for its computation upon the increase in profits above the average realized in a defined pre-war period.

It is not, however, the pre-war profits that are to be taxed. They are merely the standard by which tax liability is to be measured and because the incidence of the tax falls in a later period there is a need for assurance that the base is equitable.

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The Excess Profits Tax Act is founded on the assumption that pre-war profits were representative of peacetime earning capacity and a fair base for calculation of wartime profits. For the most part this assumption is valid and in its general application no difficulties are encountered in the calculation of the base, the computation of the tax and the several adjustments that may be necessary to assure uniformity in assessment.

On the other hand it is equally evident that the tax on the excess would be inequitable if the pre-war profits of a taxpayer were unusually depressed or if the enlarged wartime profits of a new business were accepted as the bases of taxation. In the one case the excess profits tax would be relatively high; in the other it would be relatively low.

It is the broad duty of the Board of Referees to equalize the base of taxation for new and depressed taxpayers in order that they shall occupy relatively the same position as the generality of taxpayers who have no recourse to the Board because their actual pre-war profits are a just standard.

This does not mean that taxpayers showing the same amount of total taxable profits will pay the same *amount* of taxes. It does mean that all taxpayers who have, for example, doubled their profits will pay the same *rate* of taxation. In other words, if the base of taxation is equalized, proportionate increases in profits result in identical rates of total taxation.

For the moment it should be recalled that the base for the excess profits tax is the average net taxable profits in the four calendar years from 1936 to 1939, subject to the elimination of one year's financial results under certain circumstances. The tax is levied on the increase in profits above these "standard profits" in the "standard period". The tax itself is imposed at a rate of 100% of the increase in profits less a deduction for the 18% corporation income tax and 12% flat tax already imposed on total net profits.

The effect of combining the special tax on excess profits with the combined taxes of 30% on total profits is to intro-



duce a highly progressive tax. Furthermore, the progression starts at 40% of total profits because it is provided that if a 10% tax on total profits is larger than a 100% tax on excess profits, the former tax will be imposed.

The progressive nature of the rates of tax imposed on the total income of a company with standard profits of \$100,000 is illustrated in the following table.

Taxable Profits	Income Tax at 18%	Flat Tax at 12%	Excess Profits Tax	Total Taxes	1942* Rate of Total Taxes	1941 Rate of Total Taxes
\$ 50,000	\$ 9,000	\$ 6,000	\$ 5,000	\$ 20,000	40.0%	40.0%
100,000	18,000	12,000	10,000	40,000	40.0	40.0
150,000	27,000	18,000	35,000	80,000	53.3	40.0
200,000	36,000	24,000	70,000	130,000	65.0	48.7
250,000	45,000	30,000	105,000	180,000	72.0	54.9
300,000	54,000	36,000	140,000	230,000	76.6	59.0
350,000	63,000	42,000	175,000	280,000	80.0	61.0
400,000	72,000	48,000	210,000	330,000	82.5	64.1
450,000	81,000	54,000	245,000	380,000	84.4	65.8
500,000	90,000	60,000	280,000	430,000	86.0	67.2
600,000	108,000	72,000	350,000	530,000	88.3	69.2
700,000	126,000	84,000	420,000	630,000	90.0	70.7
800,000	144,000	96,000	490,000	730,000	90.2	71.8
900,000	162,000	108,000	560,000	830,000	92.2	2.6
\$1,000,000	\$180,000	\$120,000	\$630,000	\$930,000	93.0	73.3

\*Rates do not show credit for post-war tax refunds.

It is quite apparent that two taxpayers with exactly similar taxable profits could be subject to different tax levies and rate of total tax, depending on the amount of standard profits and the growth of taxable profits. If one concern earned 12% on its capital in the standard period and 24% in the taxation period its taxes would be 65% of its income; the total tax rate would be the same for another company which increased its rate of return on capital from 6% to 12%.

It cannot be overemphasized, therefore, that the excess profits tax is an impost upon the *increase* in profits. If the base is equalized the resulting tax rate depends solely upon the acceleration of the growth of profits in the taxation period. It is of the essence of the Canadian system that if one taxpayer trebles his profits he will pay a total rate of taxation higher than that of a taxpayer who doubles his profits.

The Board of Referees has naturally concentrated its attention upon the base of taxation rather than upon the amount of taxation itself. The latter is purely a consequence of profits behaviour in the taxation period and the Board has no power to change the amount of taxation directly in the sense of recommending a reduction in the taxes payable. Changes in tax liability may follow from its ascer-

tainment of standard profits but claims for tax reduction as such are not entertained by the Board.

In effect, the Excess Profits Tax Act assumes that the average profits in the standard period were representative of the earning capacity of each taxpayer under the economic conditions then prevailing. That is the rule and for the great majority of taxpayers the taxable increase in profits is measured against this base. There is no recourse to the Board of Referees unless there is evidence that the standard profits were non-existent or abnormally low.

There is, however, little uniformity in business experience as far as individual firms are concerned. It is readily apparent that the pre-war profits of some companies might not be representative of their earning capacity, judged either by their own performance in some previous period or



by reference to the showing of their competitors in the immediate pre-war period. Profits of some taxpayers might have been unusually depressed owing to exceptional circumstances. To measure the increase in profits against this low base would be obviously inequitable and result in relatively unjust taxation.

It was to modify these inequities that in November, 1940, the Board of Referees comprising Hon. Mr. Justice W. H. Harrison, Chairman, of Saint John, N.B., K. W. Dalglish, C.A., of Montreal and C. P. Fell of Toronto was appointed. Its duties are to ascertain standard profits for depressed taxpayers and new businesses, i.e., those which commenced operations subsequent to December 31st, 1937.

Where facilities for revision of a tax base are provided it is only to be expected that taxpayers will claim for relief if any justifiable grounds are present. Unless conditions were imposed in the Act which made it clear that only exceptional depression in a particular concern and not general depression in business could make claims eligible for consideration, there would be a prospect that so many taxpayers would consider themselves depressed that the Board would be inundated with claims. This was particularly true because the years 1936-39 were not a period of peak business generally, both volume or sales and prices being lower than in some previous prosperity years.

It can be inferred, therefore, that in fixing rates of not less than 5% or more than 10% on invested capital as the standard profits to be ascertained by the Board it was hoped that frivolous claims would be avoided and awards would be restricted to socially fair earnings rates.

Earning power is, however, not the result of any innate productivity of capital and certainly not of the equity capital defined in the Excess Profits Tax Act. In most cases the 5% to 10% limitation imposed on the Board of Referees gives ample scope to ascertain realistic standard profits and correct the adverse effects of

unusual disabilities in the standard period. In other cases, however, personal talents and skills are such that capital is relatively unimportant in the earning of profits and a 10% award on the meagre capital would be far from correcting the effects of temporary depression. Conversely in cases where physical assets are ample and the management capable the capital as defined might, by accounting standards, be abnormally impaired or abnormally low due to extraordinary circumstances. In these cases too a 10% award would fail to remove or substantially modify the inequity. Where these conditions of low capital and low standard profits exist the Board is empowered to depart from the capital standard and "ascertain the standard profits on such basis as the Board thinks just, having regard to the standard profits of taxpayers in similar circumstances engaged in the same or an analogous class of business". Naturally the Board is reluctant to depart from the capital standard unless there is ample justification.

This outline of the Excess Profits Tax Act and the place of the Board of Referees makes it clear that for the most part the administration of the Act is where it should be, viz., within the Income Tax Division. The existence of the Board, however, is an assurance that where inequities are sustained they can be substantially corrected and that new businesses will not be handicapped by unjustifiable tax liabilities.

The Board is hardly to be regarded as an agency for tax relief in the sense that it reduces taxes. Its upward revisions of standard profits have that effect but they are made to assure that there will be comparability in the tax bases of all taxpayers.

While there are statutory limitations imposed on the Board there is also considerable latitude and discretion. On the whole the restrictions have not prevented the Board from devising policies which have allowed a generally consistent attitude in meeting the claims of widely diversified taxpayers.