The post-war outlook for the Canadian newsprint industry, therefore, is relatively favorable, considered both from the standpoint of future market possibilities and future sources of pulpwood supply.

What is the outlook for the industry in the Maritime Provinces? The production of lumber and wood pulp has been important there for many years, but the manufacture of newsprint paper is of comparatively recent origin. One relatively small mill commenced producing newsprint in Nova Scotia about 1923, but until 1929 its output averaged only about 20,000 tons per year. By 1930, however, two other large mills had come into production, and in 1931, the output of the three mills in New Brunswick and Nova Scotia amounted to about 225,000 tons—roughly 10 per cent of the total Canadian supply. Since then the Maritime production has averaged about 250,000 tons annually, and in one year almost equalled 300,000 tons.

The competitive position of the Maritime mills compares favorably, in general, with that of other newsprint mills in eastern Canada. Wood costs are, on the average, at least as low as those in Ontario and Quebec, and power and other costs do not differ appreciably from the averages in the other two provinces. An advantage which the Maritime mills enjoy is their location on tidewater. All three mills are situated on navigable deep water, and therefore, can be reached by ocean vessels, and one of the three is the only Canadian newsprint mill east of the Rockies which can utilize year-round water transportation. This advantage of location results in a considerable saving to the mills, for the cost of transporting newsprint from mill to market is relatively large.

On the whole, therefore, the Maritime mills appear to occupy a favorable position in the Canadian industry. The most serious difficulty they may encounter in the future is a shortage of pulpwood. At present, however, they seem to have a sufficient supply for a long time to come provided that, in the post-war era, there is no great expansion in newsprint production such as that which followed the last World War.

# The Canadian Excess Profits Tax

EDITOR'S NOTE: The tax on excess profits is one of the most widely discussed measures of Canadian war finance. On account of its complicated nature it is often misinterpreted and still oftener misunderstood. PUBLIC AFFAIRS has therefore asked two well known experts to discuss in its columns some important aspects of the tax, namely its administration and its effects on Canadian companies.

## THE EFFECT OF THE TAX ON 80 CANADIAN CORPORATIONS

By LUCY MORGAN[1]

### 1

WITH every month Canada's war economy gathers momentum. Trade totals soar to new heights, production figures climb steadily, business indicators rise. With the same dizzy speed the costs of war mount daily, an ever increasing percentage of the national output is diverted to war, and with each succeeding budget the government's tax needs dig deeper into the Canadian pocket.

The net result of war stimulation and war taxation on Canadian business has provoked speculation and controversy. Has the increased activity due to the war meant higher profits? Does available evidence bear out the extremist contention that huge profits are being made out of the war, or the equally extremist but opposite contention that business is being choked by the Excess Profits Tax? An analysis of the 1939 and 1940 annual statements of a group of eighty corporations both large and small, representing widely diverse aspects of Canadian business, suggests at least a tentative answer to these questions

[1] See Editor's Note on p. 20.

and provides a basis for speculating about future trends as the war speeds up business still further.

Perhaps the most striking fact emerging from the analysis is that in 1939 and 1940 the aggregate net profits of these eighty companies were identical to within a fraction of one per cent. Though their net income increased by nearly one-third, they devoted a much larger percentage of it to taxes—40% in 1940 as compared with about 20% in 1939—the net effect being just to drain off the increased profits resulting from war stimulation.

Over the range of companies, however, wide divergencies from this general picture existed. Taxes which just, in the aggregate, siphoned off increased income, sharply reduced the net profits of some companies and groups of companies, and left others with larger profits than in 1939.

Such a result might well have been expected from the altered tax structure. The minimum corporation tax in 1940 was 30%. In addition to the regular corporation income tax, raised after the outbreak of war from 15% to 18%, corporations were assessed under the Excess Profits Tax Act either 12% on their total profits, or 75% on the excess over a pre-war standard, whichever tax was the larger. It will be noted that, because of the alternative rate on total profits, the excess profits tax is not, as its name would seem to imply, a tax on excess profits. It is, rather, a war tax on business whether or not there be an excess of profits over the pre-war period. Naturally, therefore, the profits of companies with decreased, stationary, or only moderately increased incomes were sharply curtailed, while companies with considerably increased incomes were left with larger amounts of profit than in 1939. More than half the companies found their net profits reduced in 1940 as compared with 1939, some had maintained or only moderately increased them, and a small group showed very considerable increases. The effect on the rate of profit was to reduce the number of companies with very low rates of profit or no profit at all, and also the number of those with extremely high rates of profit. The aggregate rate of profit, that is the rate of profit of the whole group considered as a single unit, remained approximately the same.

An analysis of the companies by industrial groups throws further light on the initial effects of war taxation. All eleven of the groups into which the sample was divided showed increases in earnings in 1940, but these varied from less than 10% in the utilities and the consumer industries to well over 100% in the electrical equipment and machinery groups. Only four groups, however, namely the two just mentioned, and in addition the transportation group, and the paper companies, which rallied from their pre-war state of depression, reaped increased profits. All others found their profits reduced by percentages varying from 3% for the iron and steel group to 23% for textiles and apparel. Increases in the tax burden corresponded in general to the varying increases in earnings. While, for most groups, the percentage of net income devoted to taxes was doubled in 1940, for the highly stimulated machinery, electrical equipment and paper groups it was approximately tripled.

To recapitulate: in the aggregate, war taxation had just drained off the increased profits resulting from war stimulation. Businesses with decreased, stationary, or moderately increased incomes had suffered a cut in profits. On the other hand, most of the businesses with considerably increased incomes had not only preserved their previous profits intact, but were increasing them, though at a diminishing rate, as their volume increased. In 1940 these two sets of factors were just sufficient to offset each other.

The 1941 profit situation of the group is bound to have been affected by the complex forces at work in the Canadian war economy. Certain factors tended to restrict profits. Shortages of labour and basic materials grew steadily more serious during 1941 culminating towards the end of the year in a spate of government orders curtailing civilian production in most fields. Towards the end of the year also came the price ceiling, the "squeeze" from which has probably operated to restrict profits; the Minister of Finance has stated in this regard, "It now appears likely that profits will decline rather than increase". The change in the corporation tax which became effective in 1941—it will be remembered that the flat rate on total profits was raised from 12% to 22%, thus making the minimum corporation tax 40% instead of 30%—must have cut still further into the profits of the industries which had not been accelerated. This raising of the minimum tax could not, however, close off the avenue to increased profits open to those highly stimulated businesses paying the 75% rate, many of which, published reports indicate, definitely and substantially increased their profits in 1941. Such businesses, in increasing their volume benefited by the lower unit costs consequent upon greater utilization of plant capacity up to the point at which such factors as the difficulty of getting high quality labour began to work in the opposite direction. Moreover, the continued wartime acceleration of business may have increased significantly both the number of companies in this group and the aggregate amount of their profits, for, as we have seen, beyond a certain point, though the *percentage* of total profits retained by the taxpayer decreased as profits rose, it has been possible for the *amount* of profit to increase—considerably if the business was sharply accelerated. The *Financial Post* for January 17th, 1942, quotes "a member of a group of highly trained Toronto men" discussing the outlook for stocks in 1942, as follows: "Excess profits taxes are now known and proving less unpleasant than at first feared. They have removed the possibility of extra high profits but increased volume of business has demonstrated that it will not be an entirely profitless war for Canadian industry." It is therefore, not strictly true to say that the excess profits tax has meant that there is no profit incentive in increased output. There has been first of all the incentive of increasing business sufficiently to maintain the pre-war level of profits, and secondly the incentive of reaping the increased amount of profit possible even under 1941 schedules. Under the 1942 budget, in which the tax on excess profits has been raised to 100% with a 20% tax credit to be refunded after the war, the incentive will take the form of building up this post-war credit.

Nevertheless, uncertainty about the future, fear of post-war dislocation, the spectre of catastrophically falling prices and glutted inventories undoubtedly condition business policies at this juncture. One obvious instance is the conservative dividend policy being generally pursued by Canadian companies. Frequently even when profits per share have been doubled or more than doubled, only the normal dividend rate is being paid. Dividend payments in Canada in 1940, according to the *Financial Post Business Year Book*, were about $305 millions, slightly less than in 1939. In 1941 they were somewhat under $317 millions, an increase of less than 4%. And it must be remembered that in both 1940 and 1941 a number of companies whose dividend payments had lapsed resumed payment.

The increased working capital necessary for a larger volume of business and greater plant capacity partly explains this reluctance to increase dividends. Cash requirements have expanded with heavy inventories, enlarged output, and higher taxes. Companies are seeking to do their own financing to avoid the large bank loans with which many of them were caught at the end of the last war. In other words, increased profits, when they exist, are for the most part being ploughed back into the business to strengthen its financial position, instead of being disbursed as dividends.

Business would like to cushion itself still further against the future by obtaining a more liberal interpretation of the inventory reserve provision than the Income Tax Division has seen fit to grant. The authorities, however, have remained adamant in their decision not to allow protection for heavily expanded war-war-inventories due to extended hours or speeded methods of production of prewar machinery.

In a letter to the Secretary of the Dominion Association of Chartered Accountants, published in The Canadian Chartered Accountant for December, 1941 the Commissioner of Income Tax observes, "If . . . a reserve against increasing amount of inventory were to be allowed, it would be an invitation to the companies to say: 'Rather than handing a substantial portion of our profits to the Crown, let us buy yet more inventory'—perhaps having in mind yet further increases in cost, and thus create claims for greater and greater reserves, and thereby enforce the Crown to invest its substantial portion of the profits in inventory and thus risk the Crown's money in a precipitous decline of inventory . . . The denial of such reserve certainly requires all businesses to be very cautious and not overextend their inventory, because they realize that they are risking their own money."

That some businesses would also like to put themselves in a more favourable financial position by getting concessions in the matter of "standard profits", the yardstick against which excess profits are measured, is shown in certain remarks of Mr. Justice Harrison, Chairman of the Board of Referees, speaking before the Ontario Division of the Canadian Bar Association. An argument advanced by some taxpayers applying for a standard profit higher than that actually earned in the years 1936 to 1939 is "the claim to recoup out of profits the amounts necessary to compensate for past lean years and possible future lean years". This argument, the speaker stressed, is considered irrelevant by the Board. Remembering that the vast majority of taxpayers have not the opportunity to come before them, they consider it their duty to set the standard profit at a figure that could actually have been earned under the business conditions prevailing in 1936-39 if the taxpayer had been in business or had not been suffering from special difficulties, so that all taxpayers may feel that their standard profits represent an amount that was actually earned or could have been earned in 1936-39.

High depreciation allowances, which permit industry to write off old equipment at an accelerated pace and to pay for new plant and equipment out of untaxed wartime profits may work to its considerable advantage. Depreciation allowances for plants working two and three shifts are sharply increased and new plant erected purely for war needs may be written off in two, three, or four years, depending on its type and later usability. If the war should end just when the new assets have been written off, the companies will be the gainers by these generous depreciation allowances to the extent that the assets continue to be usable, since they will have had heavy exemptions during a period of high tax rates. On the other hand, if the war and war taxation continue after the assets have been written off, the companies will then be at the disadvantage of having no depreciation deduction from their net taxable income.

Comparisons have often been drawn between the British 100% Excess Profits Tax and the 75% Canadian tax. Those who made such comparisons were not always aware that 20% of the British tax is in the form of a tax credit, to be returned to the taxpayer after the war. The discrepancy between the two was, therefore, more apparent than real and since the imposition of the new budget even the apparent discrepancy has disappeared. The Canadian tax has been heavy and its application rigorous. If, however, as evidence seems to indicate, aggregate profits and the rate of profit have declined little if at all, business surely can have no complaint. While profiteering has so far been prevented and profits restricted though by no means stopped, little actual sacrifice has yet been asked of business. An article in the *Financial Post* for January 17th, 1942, discussing investment trends, says, "To date it must be admitted there is little evidence from published reports that payment of taxes has weakened the working capital strength of Canadian companies." The 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.

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 account 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-

EDITOR'S NOTE: Dr. Lucy Morgan is on the research staff of the Bank of Nova Scotia in Toronto. The article is a summary of a paper presented at the Annual Meeting of the Canadian Political Science Association which will be published in full, with the addition of later data, in a forthcoming issue of the *Canadian Journal of Economics and Political Science*. Courtland Elliott, with the Toronto Investment house of E. A. Ames and Co., is economic adviser for the Board of Referees.