TAXATION DECISIONS AND RULINGS

Tax Deductions from Remuneration of certain Non-Taxable Employees

Under Order-in-Council P.C. 104/2200 of 28th March, 1944, authority has been given to refrain from deduction of tax from the remuneration payable to certain employees, who by reason of the length of employment, seasonal occupation, or other reason will not be in receipt of a taxable income during the year. The purpose is to avoid having the persons concerned file applications for and await the necessary refunding being made. Where deductions are not made a Form T.D.1A must be obtained from the Inspector of Income Tax by the employee, completed, and filed with the employer. The employer must retain the completed form for inspection by officers of the department.

The terms of this Order-in-Council apply to non-taxable persons only. It is not applicable to persons such as school teachers or others who obtain work during the holiday season and who during the year have an income in excess of the minimum exemption.

Part II of the Order-in-Council is for use in the case of persons who, in the normal course, will not be taxable, although receiving wages or salary at a rate in excess of the minimum exemption. This will apply to employees who have numerous dependants, or will not work sufficiently long to earn a taxable income. For this class, exemption from withholding may be given if the full facts, including the address of employee, number of dependants, marital status, name and address of employer, and facts on which the claim for relief is based, are stated. Form T.D.1A must not be used in respect of those persons seeking relief under Part II of the Order-in-Council.

The text of the Order-in-Council is as follows:—

PART I

That employers be not required to make tax deductions at the source from the salary or wage paid to an employee who furnishes to the employer information on a form prescribed by the Minister of National Revenue declaring that the employee is—

(A) A person who, if fully employed for the balance of the calendar year at his present rate of pay, would not receive during such year total salary or wages of a sufficient amount to render him liable to income tax; or

(B) A housewife employed seasonally or temporarily for a total period during the calendar year not exceeding six months and who will not be in receipt of a total income during the calendar year in excess of $660; or

(C) A student at a school or university employed only on seasonal or part time work or in a temporary capacity during spare time or the vacation period and who will not be in receipt of a total income during the calendar year in excess of $660; or

(D) A male member of His Majesty's Canadian Forces on active service in Canada, whose service pay and allowances do not exceed $1,600 per annum, employed on civilian work during his spare time or during military leave which has been granted for a period not exceeding four months and who will not be in receipt of a total income during the calendar year (excluding army pay and allowances) of a sufficient amount to render him liable to income tax; or

(E) A resident of the United States temporarily employed in Canada for a period not exceeding ninety days and whose earnings from employment in Canada during the calendar year will not exceed $1,500.

PART II

That employers be not required to make tax deductions at the source from the salaries or wages paid to employees who satisfy the Minister that they will not be in receipt of sufficient total income for the calendar year to be liable to income tax, notwithstanding that the salaries or wages they receive during a portion of such year are at rates which would otherwise be subject to tax deductions at the source.

* * * *

Kenneth B. S. Robertson Ltd. v. *Minister of National Revenue*[1]

This was an appeal under the Income War Tax Act from an assessment made for the years 1937-8-9. Judgment allowing the appeal was given by the President of the Exchequer Court on the 6th of June.

The point involved was of interest but was decided on the facts in this particular case. The appellant company are agents for insurance brokers and act as agents for Lloyd's of London, England. Their business is entirely with brokers in the United States, and the writing of Workmen's Compensation, Employers' Liability and Occupational Disease Insurance contracts.

The premium on such policies, which usually have a life of one, and in some cases, two years, is based on the remuneration paid to the employees during the period of coverage. Consequently, it is not possible to determine the actual premium until the expiration of the policy. A minimum premium was in

[1] Not yet reported.

any event payable on the issuing of the policy, and it could be terminated at any time during its life, on thirty days' notice by either party.

In practice, it developed that in every case, the employer paid an advance fee, which was in excess of the minimum premium. The advance fee was applied against the actual premium when determined, and an additional payment, or a refund was made, depending on whether the advance fee was or was not sufficient.

The appellants allocated the advance fee over the life of the contract, by setting up a reserve at the close of each taxation period for that portion of the fee which was applicable to the period of time in the next or succeeding periods. This was disallowed by the Minister on the grounds that such a reserve was expressly prohibited by section 6 (1) (d) of the Income War Tax Act as follows:—

> 6. (1) In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of
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> (d) amounts transferred or credited to a reserve, contingent account or sinking fund, except such an amount for bad debts as the Minister may allow and except as otherwise provided in this Act.

It was also contended that income was chargeable with tax in the year received, and not in the year when earned in accordance with the judgments in *Capital Trust Corporation et al.* v. *Minister of National Revenue.*[2]

In his judgment Thorson J. indicated some doubt as to the decision in *Western Vinegars Ltd.* v. *Minister of National Revenue.*[3] In this case, the company set aside a reserve for containers for which they made a charge when shipped but agreed to make a refund therefor when returned. Angers J. had accepted the contention of the appellants that the amounts to be refunded were not in fact a reserve, but were merely amounts held, not upon a contingency, but on the certainty that they would be repaid. Thorson J. indicated that he thought such profits should be brought into charge the year received, and payments of refunds allowed as an expense when made.

On the facts in this case, it was held that the so-called advance fee, to the extent that it was in excess of the minimum premium was not income, but was merely a deposit made to secure the payment of the actual premium when determined. The

[2] [1936] Ex. C.R. 163; [1937] S.C.R. 192.
[3] [1938] Ex. C.R. 39.

minimum fee, being determined, was income in the year received. The balance of the advance was brought into charge only when the policy expired and the whole premium determined.

On this finding, it was possible to distinguish the facts in *Brown* v. *Helvering.*[4] This was a judgment of the Supreme Court of the United States where it was held that a general fire insurance agent who received overriding commissions, subject to their being refunded upon the happening of a future contingency, were nevertheless required to treat such receipts as income in the year received.

His Lordship also expressed his concurrence with the decision in the *Capital Trust Corporation* case, *supra.*

The judgment does not give to the appellant the whole relief sought. The result will be that the minimum premium must be treated as income in the period when the advance fee is received, and the balance of the actual premium in the year received after being ascertained. It does not permit any departure from the rule as given in *Brown* v. *Helvering, supra,* as the appellant is not entitled to allocate the premium over the life of the policy.

It is also indicated that a taxpayer is entitled to look at the nature of his receipts. If it is not income, then the fact that it might be received in the course of the operation of a business does not necessarily bring it within the scope of the Income War Tax Act.

* * * *

Depreciation under the Income War Tax Act

In determining the profits arising from a business in which, for the purpose of earning profits, plant, machinery or other equipment is used, it is a recognized principle that a reserve should be set aside, in order to replace the wear and tear arising from the use of such assets. Such assets must necessarily have a life, extending beyond the taxation year, as otherwise their annual replacement would be charged as an operating expense. But to the extent that they are used, or their useful life is shortened, by the operations necessitated in earning the income of any period, there has been an expense incurred in earning the income.

Inasmuch as the assets against the deterioration of which depreciation may be claimed, are capital assets, any charge in

[4] 291 U.S. 193.

respect of them would be prohibited by section 6 (1) (b) and permitted by section 6 (1) (n) as follows:

> 6. (1) In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of
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> (b) any outlay, loss or replacement of capital or any payment on account of capital or any depreciation, depletion or obsolescence, except as otherwise provided in this Act;

Section 6 (1) (n) provides:

> (n) Depreciation, except such amount as the Minister in his discretion may allow, including such extra depreciation as the Minister in his discretion may allow in the case of plant and equipment built or acquired to fulfil orders for war purposes;

There is thus created the situation whereby an expense, recognized as being inherent in any manufacturing operation, is prohibited, except to the extent that it may be granted in the discretion of the Minister of National Revenue.

This condition has existed since 1940 when section 6 (1) (n) was enacted, replacing the first part of section 5 (1) (a), which was repealed at the same time. The part repealed was as follows:

> 5. (1) "Income" as hereinbefore defined shall for the purpose of this Act be subject to the following exemptions and deductions:—
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> (a) Such reasonable amount as the Minister, in his discretion, may allow for depreciation.

Prior to 1940 the position therefore was that depreciation could be charged in such "reasonable" amount as the Minister might allow.

The interpretation of section 5 (1) (a) first came before the Exchequer Court in the appeal of *Pioneer Laundry & Dry Cleaners Ltd.* v. *Minister of National Revenue.*[1] In this case the appellant company had acquired, in return for its shares, certain fixed assets and equipment, and had set up such assets on its books at the value of the shares. Such assets had been depreciated, practically to the extent of their original cost on the books of the predecessor company owners. Depreciation by the appellant was claimed at the usual rates on the values as set up in its books. The shareholders in the appellant company were the same as in the previous companies owning the assets, and their interests were proportionate to the value of the assets which they had exchanged for their shareholdings.

[1] [1938] Ex. C.R. 18.

The Minister allowed depreciation at the regular rate on the value of the assets as they were on the books of the previous owners, on the grounds that there was no real change of ownership; and that in any event a reasonable amount had been allowed by the exercise of the statutory discretion vested in the Minister. These views commended themselves to Angers J., who accordingly dismissed the appeal.

The appellant company appealed from this judgment to the Supreme Court of Canada.[2] In that Court the judgment of Angers J. was affirmed by a majority, the Chief Justice and Davis J. dissenting. The dissenting judgment was on the grounds that the Minister in exercising his discretion had acted upon improper grounds in not recognizing the separate legal entity of the appellant company, notwithstanding the similarity of its shareholders with those of the previous owners of the assets. At page 5 Davis J. said:

> The Commissioner of Income Tax put his denial of any amount for depreciation on the said machinery and equipment upon the ground that "there was no actual change of ownership of the assets" and they were "set up in the books of the taxpayer at appreciated values". In my view that was not a proper ground upon which to exercise the discretion that had been vested in the Minister. The Commissioner was not entitled, in the absence of any fraud or improper conduct, to disregard the separate legal existence of the company, and to inquire as to who its shareholders were and at what figures these assets had been carried on the books of some other individual, partnership or corporation.

In the judgments of Kerwin J. and of Hudson J., and with which Crocket J. concurred, the question as to the succeeding ownership was not considered but the judgment appealed was affirmed on the ground that the Minister had exercised his discretion in a proper manner.

The case was then taken to the Privy Council[3] where the judgments in the lower courts were set aside. In delivering judgment Lord Thankerton said at page 136:

> In their Lordships' opinion, the taxpayer has a statutory right to an allowance in respect of depreciation during the accounting year on which the assessment in dispute is based.

And at page 137:

> Their Lordships agree with the Chief Justice and Davis J. that the reason given for the decision was not a proper ground for the

[2] [1939] S.C.R. 1.
[3] [1940] A.C. 127.

exercise of the Minister's discretion, and that he was not entitled in the absence of fraud or improper conduct, to disregard the separate legal existence of the appellant company, and to inquire as to who its shareholders were and its relation to its predecessors. The taxpayer is the company, and not its shareholders.

Regarding the main point involved in the appeal from the point of view of the taxing authorities his Lordship said:

It becomes unnecessary to consider a further question which was debated — namely, whether a taxpayer who has already received in previous tax years allowance for depreciation amounting to 100 per cent of the book value of the assets, is entitled to any further allowances.

This last statement was perhaps badly worded and has no doubt given rise to some misunderstanding of the effect of the judgment. The point involved was whether substantially the same persons could, through the creation of a new entity, receive further tax relief by way of depreciation, upon assets which had already been fully written off. It is obvious, that if this could be done, then either the rate at which the assets were depreciated was excessive, or that a tax allowance could be obtained indefinitely on the same assets.

The Minister of National Revenue, relying upon the discretionary power given him in section 5 (1) (a) of the Act as it then was, assessed the appellant for the subsequent years 1934 to 1939 and allowed as depreciation upon the assets the sum of $1.00 in each year. This allowance was appealed in 1942. It came before the Exchequer Court and Robson, Deputy Judge, allowed the appeal[4] upon the grounds that the nominal sum of $1.00 was not a "reasonable amount" for depreciation. He said at pages 180-1:

I have to say, with deference, that I think the course pursued was not a consideration of a reasonable amount for depreciation within the intention of the Act. I have not had the benefit of any explanation, simply the Minister's decision.

It seems to me that the experience of this case shows that the sums allowed the previous owners for depreciation were too large and that the property had not depreciated to the extent of the sums allowed. The then owners possibly made a gain to which they were not entitled, but nothing can be done about that here.

One other appeal was before the courts upon the application of section 5 (1) (a) prior to its amendment in 1940. This

[4] [1942] Ex. C.R. 179.

was *Walkerville Brewery Ltd.* v. *Minister of National Revenue.*[5] The facts in this case disclose that the appellant company, incorporated under Dominion charter, was the successor to an Ontario company of the same name. The assets of the vendor company were appraised at an amount greatly in excess of their depreciated value on the books. There was no change in shareholders.

Depreciation was allowed the appellant company on the depreciated value of the assets on the books of the vendor company at the usual rates. The company sought to charge depreciation on the appraised value which it was claimed had been the actual purchase price. In dismissing the appeal MacLean J. said at page 128:

> The facts here seem to indicate that the Minister based his valuation of fixed assets for the ascertainment of "depreciation" largely upon the cost of the same to the vendor company from which the appellant company acquired the same, and which basis was adopted by the appellant itself for two years. Due allowance was made for depreciation of any new assets in the meanwhile acquired by the appellant company. It seems to me that the Minister, in the exercise of his discretion, in fixing the "reasonable amount" that should be allowed for depreciation adopted a method or basis that is hardly open to attack, and at least I was shown no authority to the contrary. I have not been satisfied that the Minister adopted any wrong principle in determining the amount that should be allowed for depreciation, or that the amount allowed was not a reasonable and proper one.

The position therefore since 1940 when section 6 (1) (n) became applicable is that depreciation is not allowed, except in such amount as the Minister in his discretion may allow. It is true that the tax department has permitted the circulation of certain circulars indicating the rates at which depreciation on various items of wasting assets may be charged, The status of the circulars was discussed first in the *Pioneer Laundry and Dry Cleaners Ltd.* appeal, *supra,* and in the Privy Council. Lord Thankerton said of them:

> Their Lordships agree with the view of Crocket and Hudson JJ. that these departmental circulars are for the general guidance of his officers, and cannot be regarded as the exercise of his statutory discretion by the respondent in any particular case.

It is therefore theoretically not possible for any taxpayer to determine his true profits after allowing for depreciation, inasmuch as it is entirely in the discretion of the Minister as to

[5] [1942] Ex. C.R. 124.

the amount which may be deducted. In practice this does not happen, as the rates published are generally adhered to, and the discretion exercised otherwise only under unusual circumstances. This condition does provide a safeguard to the revenue, and avoids the possibility of tax concessions arising through the transfer to nominally new owners, of assets which have already been fully depreciated.

Inasmuch as depreciation is allowed as being an item in the cost of production, it follows that in those periods when the plant and equipment are not used to their fullest extent there is a decrease in the actual wear and tear. Accordingly where depreciation is taken by the straight line or reducing instalment method, if the usual rate is used to determine the amount, there would be an allowance in excess of that actually incurred. This has been recognized by the taxing authorities, and provision has been made whereby in those periods when the plant and machinery have not had normal use one-half of the depreciation may be claimed. Such a claim would require to be substantiated by figures showing the decrease in its use over that of a normal period. Conversely, there may be periods of industrial activity when it is necessary to use the plant and machinery in excess of that normally done. This has also been recognized as a factor in determining depreciation, and an application for an increased allowance would be entertained if supported by the proper relevant data.

The conditions created by the war resulted in there being enacted in 1940 that part of section 6 (1) (n) reading as follows:

> including such extra depreciation as the Minister in his discretion may allow in the case of plant and equipment built or acquired to fulfil orders for war purposes.

To assist in determining the amount of such extra depreciation, there has been appointed a Board known as the War Contracts Depreciation Board. This Board, which acts in an advisory capacity to the Minister, will receive applications for increased depreciation allowances and make recommendations to the Minister on the basis of the facts presented. This, of course, applies only to the case of plant and equipment which are acquired for the purpose of fulfilling orders for war purposes, and which would not have a useful peacetime life. The general practice of the Board has been to recommend that the capital costs of the plant and equipment be written down to their peacetime value against the profits acquired under war contracts.

By section 7, chapter 14, Statutes of 1943, effective as of the 20th May, 1943, there were three provisos added to section 6 (1) (n) as follows:

> Provided, however, that the Minister shall not allow a deduction in respect of depreciation of assets owned by an incorporated taxpayer from the income of the said taxpayer if he is satisfied that the said taxpayer directly or indirectly had or has a controlling interest in a company or companies previously the owner or owners of the said assets or that the said previous owner (which term shall include a series of owners) directly or indirectly had or has a controlling interest in the said taxpayer or that the said taxpayer and the previous owner were or are directly or indirectly subject to the same controlling interest and that the aggregate amount of deductions which have been allowed to the said taxpayer and/or the said previous owner in respect of the depreciation of such assets is equal to or greater than the cost of the said assets to the said previous owner or to the first of the previous owners where more than one :
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> Provided further that in the case of the sale of immovable assets (not including machinery or equipment) in respect of which special depreciation has been allowed, the Minister may revise the assessments of the vendor for the years when the special depreciation was allowed, by disallowing as a deduction a pro rata portion of the special depreciation allowed to the taxpayer in each of the said years, to the extent of the excess of the selling price over the depreciated cost of the said assets, less the amount of depreciation normally allowed on the said assets, and less the excess, if any, of the selling price over the undepreciated cost of the said assets:
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> And provided further that as used in the next preceding proviso the term "special depreciation" shall mean deductions in respect of extra depreciation and other special depreciation or allowances in lieu of depreciation which are in excess of depreciation normally allowed, and the term "depreciated cost" shall mean cost to the taxpayer less depreciation allowed together with special depreciation.

These provisos were evidently enacted to clear up any doubt as to the position which would be created under circumstances similar to those which arose in connection with the *Pioneer Laundry and Dry Cleaners Ltd.* and the *Walkerville Brewery Ltd.* cases referred to above. In connection therewith, it has been indicated that "controlling interest" would be interpreted on the basis of the definition approved in *British American Tobacco Company, Limited* v. *I.R.C.*[6]

The second proviso relates only to immovable assets. While it is probable that this was motivated by the fact that the peacetime value of machinery and movable equipment could be

[6] [1943] 1 All E.R. 13 at p. 15.

reasonably ascertained, this, however, would not hold true in the case of buildings or other immovable assets, for which a peacetime use might be found although not apparent at the present time. In such event and where such asset has been depreciated under the special classes referred to herein, power is given to reopen the assessments and add back that amount of additional depreciation which subsequent events prove has not been actually incurred.

The third proviso is a safeguard in the practice of the tax department whereby normal depreciation, if incurred, is allowed, together with such additional depreciation as may be granted either by reason of the recommendation of the War Contracts Depreciation Board or the accelerated depreciation allowed by reason of the abnormal use of the machinery and plant. Any depreciation added back will be restricted to the amount of such extra depreciation as has been granted, and which in the happening of events is found to be in excess of that actually incurred.

A Departmental Committee on Income Tax was established in England in 1905 to consider amongst other matters—

> the allowances made in respect of the depreciation of assets charged to capital account.

In its report the Committee quoted the section of the English Act, first enacted in 1878, which permitted the Income Tax Commissioners to

> allow such deduction as they may think just and reasonable as representing the diminished value by reason of wear and tear during the year of any machinery or plant used for the purposes of the concern.

In discussing this provision of the law the report says:

> The interpretation of this enactment has formed the subject of more than one reference to the Courts, and even now it does not appear to be quite clear whether the judicial decisions obtained require the section to be read as meaning no more than this, that loss by depreciation may be allowed even though no expenditure has been incurred in making it good by repairs, or as meaning that, after all damage by wear and tear has been made good by repairs, short of renewal, a further allowance may be made in respect of the imperceptible and irremediable deterioration due to age.
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> The opinion of the Board of Inland Revenue and the practice follows the latter and more liberal interpretation, which seems to us the correct one.

Under the English Act allowance for depreciation is only upon machinery and plant. It was said in one case that "it is impossible to define what is meant by plant and machinery."[7] There have, however, been certain assets eliminated as not coming within the category. It has been held that fruit-bearing or revenue producing trees are not subject to depreciation.[8] But in such cases all the expenses of bringing the trees to production are allowed as a charge in the year incurred. Therefore the only amount that could be considered as capital cost would be that incurred in first starting an orchard or plantation and up until the trees commenced to produce revenue.

In the case of *Earl of Derby* v. *Aylmer*[9] a claim was made for allowance for diminished value of two stallions valued at £60,000. The appellant here admitted that he had no capital cost or outlay, the animals having been bred by him. The allowance was based on the difference between the estimated value of the stallions as at the beginning and end of the taxation period. In discussing the appeal Rowlatt J. said:

> All I am asked to decide here is whether Lord Derby brings this case within the words of section 12 of the Act of 1878. Now, those words authorize such deduction as the Commissioners may think just and reasonable as representing the diminished value by reason of wear and tear during the year. Now, that applies to plant which has a diminished value by reason of wear and tear during the year. It applies to plant, the use of which in the business by wearing it out diminishes its value at the end of the year. and of course it is perfectly plainly applicable to anything like machinery which is being worn out by the use . . . .
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> But I am clearly of opinion that the diminished value of a breeding animal, merely due to the fact that having lived a year it is a year nearer its end, and therefore is from that point of view less valuable, is not within this section. . . . . That diminished value, by reason of the efflux of time year by year of an animal or a tree, does not seem to me to be diminished value by reason of wear or tear; it is simply diminished value because you have invested your money in a source of production which is a wasting source of production. . . . .

This is similar to the practice in this country, where depreciation is allowed on the initial cost, and repairs are charged as an expense in the year in which made.

There are said to be three methods by which depreciation may be determined and apportioned over the life of the asset.

[7] *Daphne* v. *Shaw*, 11 T.C. 256 at p. 258.
[8] *Vallambrosa Rubber Co. Ltd.* v. *Farmer*, 5 T.C. 529.
[9] 9 6 T.C. 665.

1. A straight line method by which an equal proportion of the original cost is written off each year.

2. A reducing instalment method whereby a fixed percentage is taken off each year on the book value of the asset as it is written down each year.

3. By valuing the asset each year, and writing off only the amount by which its value has decreased during the year. This would result in uneven amounts being taken annually, and in some years none at all.

In practice the straight line method is generally used in this country as being the most simple. It can therefore be readily seen that with the repairs being charged annually the life of the asset may continue beyond that contemplated when the rate at which the depreciation will be determined was set. Under a ruling issued by the Department therefore, depreciation is allowed only to the extent of 80% of the original cost, and thereafter upon 20% of the cost until the asset has been fully written off. This rule is not applied in respect of certain classes of assets, such as those having a life of five years or less, or those which do not have a value in excess of $25,000. It also does not apply to assets owned by farmers, or which are depreciated according to the year acquired.

The introduction of the so-called 80% rule produces a method of computing depreciation somewhere between the straight line and the reducing instalment method. It appears to be equitable and works out well in its application.

In addition to depreciation allowed on plant and equipment actually used in the business, the practice has been to permit an allowance upon assets from which income is derived, such as houses, apartments and buildings. Depreciation on intangible assets, such as goodwill or trade marks, is not allowed, although the cost of a patent is permitted to be amortized over its life, and this is in effect depreciation.

It is permitted, by ruling of the Department, on law libraries, although it was said in *Daphne* v. *Shaw*, *supra*, that a legal library was not "machinery or plant" within the contemplation of the term in the English Act. It is not extended to include plants or breeding animals, and where horses are used in a business, the cost of acquiring such animals is allowed to be charged as an expense of operations.

Land is not subject to depreciation. It is possible that it might fluctuate in value from year to year, but it would be difficult to state that it suffers from wear and tear. This is true even of such property which has been created by filling in.

Where an estate consists in whole or in part of houses or buildings, then depreciation may be allowed, but if the amount set aside as depreciation is in fact paid over to a beneficiary having a life interest in such estate, such amount is treated as taxable income of the recipient. This is on the basis that what such life tenant is receiving is only income.

Obsolescence is expressly prohibited under section 6 (1) (d). This is clearly not depreciation but is a capital loss accelerated by the asset becoming unsuitable for the purpose for which it was intended. It would seem that if an asset were expected to be, or was of a class which quickly becomes obsolete, then these factors should be taken into consideration in determining its useful life and the rate at which it should be depreciated.

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Ottawa.