Recommendations for Amendment of the Income Tax Act*

Tax Evasion — Sections 125 and 126

The principal objection to the Income War Tax Act was that because its incidence was so often dependent upon the exercise of Ministerial discretion there was uncertainty as to the application of many of its provisions. The new Income Tax Act has done much to clarify the meaning of various sections and in particular Ministerial discretion has for the most part been replaced by a rule of law. Credit is due those responsible for their achievement in this important matter.

However, some of the provisions in the new Act designed to prevent evasion are so vaguely worded that their meaning is far from clear and their application consequently uncertain. Thus the benefits derived from the removal of discretion and the clarification of many provisions have been largely offset.

It is fundamental in a free society that the subject should be protected from the exercise of arbitrary power by the provision of reasonable access to the courts of law and that men are entitled to foreknowledge of what conduct is forbidden and subject to penalties. For this reason penal laws above all should be clear and certain. Vagueness and uncertainty in such enactments must always leave men in doubt as to whether certain actions are within the law and as to when, if at all, their conduct will be held wrongful.

Attention is directed to section 126 of the Income Tax Act, which confers the widest power on the Treasury Board to counteract so-called improper attempts at evasion. That the prevention of evasion is a laudable object is not denied. But section

*The recommendations agreed upon at a joint meeting of the Legislation Committee of the Dominion Association of Chartered Accountants and a Committee of the Taxation Section of the Canadian Bar Association and forwarded to the Hon. D. C. Abbott, K.C., on February 7th, 1949. With this brief the practice of submitting to the Minister of Finance recommendations prepared jointly by committees of the Canadian Bar Association and of the Dominion Association of Chartered Accountants, which commenced several years ago but was not followed in 1948, has been resumed.

126 endeavours to achieve this desirable end by means which cannot be so described. Its broad effect is to constitute the Treasury Board a court of censorship with power to impose punishment for conduct which it considers immoral or reprehensible.

While an appeal lies from an assessment made pursuant to the Treasury Board's direction it is to the Exchequer Court not to the Income Tax Appeal Board, and it is thus open to the strong objection, based on the expense and delays of appeal, which gave rise to the more expeditious and cheaper appeal to the Income Tax Appeal Board. The effect of this is, of course, to inhibit appeals and thus to give undue persuasive force to the opinion of treasury authorities in regard to any transaction which may incur their disapproval. Moreover the section does not in terms give the Exchequer Court power to review the decision of the Treasury Board.

This section further declares that it suffices that one of the main purposes for entering into the transaction was the *improper* avoidance or reduction of taxation, even though such avoidance or reduction was not *illegal*. This distinction between impropriety and illegality creates a most difficult problem of construing the intent of Parliament, particularly in view of the long-standing and frequently repeated rule that a taxpayer is not bound so to arrange his affairs as to incur the greatest burden of taxation, but on the contrary is entitled so to arrange them as to incur the least burden of taxation. When, then, does effort to minimize the tax burden become improper? If it involves fraud or deceit or other wrongful conduct, clearly no extraordinary provision is required to safeguard the revenue. Here again the effect of these vague and doubtful provisions, coupled with the difficulties in the way of access to the courts, will be in many cases to induce hesitant taxpayers to compromise matters in dispute.

As intimated by the Minister of Finance in 1943, this extraordinary provision was deemed necessary purely as a wartime measure. It has no place in a democratic country in time of peace. In this connection it may be pointed out that the almost identical provision in the British Act was never applicable to income tax at any time, but only to the excess profits tax. With the repeal of excess profits tax in that country at the end of 1946 there is no longer any such extreme provision in the British law. It seems deplorable that it is still deemed essential in this country, particularly since virtually all other wartime emergency powers have been abandoned.

Much of the same criticism is also directed towards section 125 of the new Act. This section is couched in language of the widest kind, and its effect is to create a quasi-discretionary power in the Taxation Division to single out particular transactions for disapproval. So far as subsection (1) is concerned, it is difficult to see why section 12(2), which will disallow any expense which is not reasonable in the circumstances, is not sufficient. Subsection (2) is of such an all-embracing nature as to put it quite beyond the capacity of any taxpayer to foresee the consequences from a taxation point of view of many transactions which he may wish to enter. It creates uncertainty in the law and in the minds of Canadian citizens.

Should a taxpayer evolve a method of evasion which is not caught by the statute, Parliament can close the loophole by legislation apt for the purpose if Parliament, not the Treasury Board, deems it advisable to do so. It is better to suffer an occasional loss of revenue, regrettable though it be, than to perpetuate a set of legal principles which are foreign to our form of society and the character of our people. Canadians should be governed by the law as enacted by Parliament and interpreted by the Courts.

It is recommended that sections 125 and 126 be deleted from the Act.

Appropriation of Property to Shareholders — Section 8(1)

Section 8(1) is objectionable because

(a) the amount to be taxed to the shareholder is not limited to the undistributed income on hand of the company as was the case in section 18 of the Income War Tax Act, the precursor of this section;

(b) paragraph (b) should only apply to appropriations other than those made pursuant to *bona fide* business transactions, otherwise it would apply to such a transaction as the redemption of bonds and debentures owned by shareholders;

(c) paragraph (c) is couched in such wide terms as to be incapable of precise definition.

It is recommended that paragraph (b) be made applicable only to transactions which are not *bona fide* business transactions and that paragraph (c) be deleted from the statute, and that the whole subsection be amended so that it is applicable only to the extent of the undistributed income on hand of the company.

Capital Cost of Property — Section 11(1)(a)

The allowance under this subsection ought to be a matter of right, as was the case prior to 1940, so that taxpayers shall be entitled to recover their capital cost from income. Any regulations issued hereunder should be confined to the matter of rates only.

With regard to the regulations it is pointed out that the loss carry-over provisions have very largely eliminated the need for detailed and rigid rules in respect of depreciation allowances, in particular, the 50% rule for years of loss.

The regulations to be issued under the Act should permit depreciation allowances in line with business requirements and, in particular, a reasonable latitude as to rates of depreciation should be acknowledged.

It is recommended:

(1) that section 11(1)(a) be amended to read as follows,

"(a) such reasonable part of the capital cost to the taxpayer of property, or such reasonable amount in respect of the capital cost to the taxpayer of property as shall be prescribed by regulation", and

(2) that the rates to be allowed should be in the nature of guides and the taxpayer should be permitted to claim allowances at higher or lower rates within reasonable limits subject to a provision that in the event of disposal of the asset at a profit or a loss (calculated on the depreciated value for tax purposes) the amount previously deducted for depreciation be adjusted in the year of disposal by reference to the normal rate, to the extent of the amount of such loss or profit.

Inventory Valuation — Sections 4, 14(2), 114(1), 127(1)(v)

Section 14(2) contemplates methods of valuing inventories other than the "lower of cost or market". In this connection it may be pointed out that each of the words "cost" and "market", neither of which is defined in section 14(2), has more than one meaning in business and accounting usage. Accepted accounting principles recognize some half dozen bases for the determination of "cost" and at least three for the determination of "market" value. (See Appendix A attached.)

It is recognized that power to prevent tax evasion must be ample and that if taxpayers are allowed to change from one manner of inventory valuation to another freely and without restriction of any kind tax evasion would be possible. If this could be done under section 4 standing alone, it would seem that advantage would have been taken under the British Act, which has no specific provision in respect of inventory valuation but leaves the matter to be decided by sound commercial usage and accounting principles, but such does not appear to have occurred. Sound commercial usage and accounting principles oppose a change in the manner of valuing an inventory unless for a sound business reason. It follows that under section 4 a taxpayer would not be free to change his method of inventory valuation as the spirit moved him and that in every case the Revenue, because it has the power to assess, would be protected by requiring any taxpayer to establish the validity of his reasons before a court.

Perhaps the most desirable result from the repeal of section 14(2) would be the preservation of flexibility in the law to meet the complex and ever changing conditions in which the thousands of enterprises in this country operate, while at the same time safeguarding the revenue. Rigidity of the law on matters of so much concern to business would be a most serious handicap to Canadians now engaged in the greatest period of commercial and industrial expansion in their history.

It is recommended that section 14(2) be deleted from the Act.

Method of Computing Income — Sections 4, 14(1) and 129(9)

Subsection (1) of section 14 deals with the "method for computing income from a business or property", and provides that once a method has been accepted such method shall be continued *unless the Minister concurs* in the adoption of a different method.

Ministerial discretion should not be reintroduced into the law, particularly in relation to the "method of computing income" which, for lack of definition, may cover a very wide field, since it may well introduce an undesirable rigidity into business and commercial practice.

It is recommended that section 14(1) be amended to read:

> When a taxpayer has adopted a method for computing income from a business or property for a taxation year and that method has been accepted, income from the business or property for a subsequent year shall, subject to the other provisions of this Part, be computed according to that method unless the taxpayer has varied his method in order that it will more clearly reflect the income.

Consolidated Returns — Section 75

The penalty tax of 2% on consolidated returns is a deterrent to a desirable practice. Both from the point of view of the Revenue and of business the filing of consolidated returns should be encouraged. They simplify the tax administration through making it unnecessary to police inter-company transactions and, particularly since enactment of the loss carry-over provisions, give no unwarranted advantage to the companies included within the consolidation.

It is recommended that the 2% additional tax applicable to consolidated returns be eliminated.

Reserves — Section 12(1)(e)

Reserves should be permitted to provide for costs and expenses which are an ordinary risk of business already transacted and which would be deductible as an expense if incurred in the taxation period, *e.g.*, a reserve for obligations to repair or replace products already sold (warranties or guaranties). These should be permitted on the same basis as reserves for doubtful debts, *i.e.*, where the amount may be reasonably estimated on the basis of the experience of the business or of other businesses of the same class.

The acceptance of this proposal would involve making some provision for existing reserves which hitherto have not been allowed under the law. The simple approach would be to allow these in the first year the change is made or otherwise spread them over a short period of years.

It is recommended that the Income Tax Act be amended to permit the deduction of reserves covering costs and expenses which are an ordinary risk of business already transacted to the extent that they would be deductible as expenses if incurred in the taxation period.

Personal Corporations — Section 61

In enacting the new provisions respecting personal corporations the exemption of dividends paid out of capital has not been repeated. Subsection (6) of this section violates the principle that for taxation purposes personal corporations are regarded as mere conduits for channelling receipts to the shareholders and that it is the latter who are charged to the tax. The eventual result of the dropping of this exemption will merely be to force the winding-up of personal corporations from time to time and thus add a needless complication to the operation of such corporations without achieving any desirable end.

This omission may also have unfortunate and probably unforeseen consequences, in view of the transitional provisions, in that it may prevent a personal corporation from continuing to distribute its income by way of tax free dividends if it has in the past taken advantage of the old exemption for dividends paid out of capital. Unless the old exemption is restored section 61 should be amended to make it quite clear that subsection (6)(b) thereof refers only to exempt dividends paid out of the income of the personal corporation, and not to dividends paid out of capital (during the years 1938 to 1948 inclusive) and exempt under the last sentence of section 21(6) of the Income War Tax Act.

Attention is also called to the extremely harsh penalty imposed upon the chief shareholder of a personal corporation, by section 61(7), for a mere technical failure to file a statement of assets and liabilities and income of the personal corporation with his return. No such penalty should be imposed if the shareholder discloses his control of the personal corporation unless he wilfully refuses to supply proper details upon request. There are sufficient penalties elsewhere in the Act for failure to include his share of the income.

It is recommended that the former basis of taxation in respect of personal corporations be restored and that the penalty under subsection (7) be deleted.

Interest on Indebtedness — Section 11(1)(c)

Expenses incurred in connection with a bond issue such as legal fees, printing costs and so forth, and the amortization of bond discount might well be allowed as deductible expenses with due provision, of course, that both the effective interest and the nominal interest rates shall be reasonable. Provision would also have to be made to exercise control over transactions between related companies. It is appreciated that this will require consideration of the basis upon which the recipient shall be taxed. In appropriate cases, section 7 which deals with blended payments of interest and principal may be invoked to bring the effective rate into charge.

The recent decision in the *McCool* case, which disallowed the interest upon the balance of the purchase price of a property used in the business because it was not "borrowed" capital, is at variance from ordinary commercial practice and the practice which prevailed under the Income War Tax Act. The Act should be amended to bring its provisions into line with accepted commercial and business practice.

It is recommended

(1) that section 11(1)(c) be amended to allow deduction of interest at the effective rate, and
(2) that its provisions be broadened to counter the effect of the recent decision in the *McCool* case.

Management Fees — Section 96(1)(f)

The imposition of a tax upon fees paid to non-resident corporations in respect of management, technical, professional or other services, information or advice, know-how, etc., is an undesirable innovation. In many cases the tax would be imposed on gross rather than net income and is thus in the nature of an excise tax. This paragraph is contrary to the spirit of the convention and may well result in the double taxation which the convention sought to avoid. At a time when other countries are employing every device possible to obtain technical information from all sources, obstacles should not be placed in the way of legitimate and desirable attempts by Canadians to obtain technical and specialized knowledge from other countries. It is contrary to our national interest to increase the cost of acquiring useful knowledge. While this tax is imposed on the non-resident it will tend to be passed back eventually to the Canadian purchaser of the information and ultimately to Canadian citizens generally.

It is recommended that section 96(1)(f) be deleted from the Act.

Undistributed Income

It is recommended that a definition of undistributed income be incorporated in the Act in the terms used in section 94 of the Income War Tax Act, subject to two small changes:
(1) presumptive dividends as well as actual dividends should be deducted in computing undistributed income (see section 20 of the Income War Tax Act);
(2) any income derived from fiscal periods ending prior to July 1st, 1917, should be excluded from the computation, inasmuch as the Income War Tax Act was not applied to periods prior to that time.

Deduction for Foreign Tax on Dividends from Subsidiaries — Section 37

The tax credit provided for in this section may give little relief because of the loss carry-over provisions in the foreign country, with the result that the income may be taxed three times, once in the foreign country, once in Canada when the dividend is received by the Canadian holding company with no tax credit under section 37, and again in Canada when the Canadian holding company pays a dividend to its shareholders.

This complicated provision is designed to grant relief in respect of the tax paid by foreign subsidiaries and to recover the difference between the domestic rate and the foreign rate where the latter is the lesser. As the difference between domestic and foreign rates narrows, the amount of tax recovered under these provisions becomes smaller, and in any event is probably not significant.

It would be more equitable to the taxpayer and simpler of administration if foreign dividends received under the circumstances set out in section 37 were exempt from tax when received by the Canadian holding company.

It is recommended that dividends from foreign subsidiaries be exempt from tax in the hands of their Canadian holding company.

Loss — Section 127(1)(w)

The definition of "loss" contained in the Act should be amended to take into account the suggestion regarding the exemption of dividends from foreign subsidiaries. Moreover, the definition of loss is ambiguous in regard to the treatment of exempt income.

It is recommended that exempt income be specifically excluded in the computation of a business loss.

Enforced Distribution of Undistributed Income — Section 9(6) and (8)

Section 9(6) and (8) does not provide adequate practical means to enable a taxpayer shareholder to appeal an assessment levied pursuant to notification under section 9(6). Moreover, the absence of any provision permitting the company itself to contest the assessment on its shareholders is a serious drawback. Any contestation of the notification will be upon assessment of the shareholders and therefore long after the ninety-day period in which case if the appeal is lost a double tax will be imposed, unless the company has foregone its objection and paid out the amount in question within the ninety days.

As to the whole question it would appear that the section in its present form and with its lack of certainty with respect to appeal will act as a club in the hands of the Assessment Department without any really effective recourse to the courts.

Any company attacked under this section would in effect have to make its peace with the Minister within ninety days after the mailing of the notice or else unduly penalize its shareholders. Ninety days, it is submitted, is not sufficient time to gather together all the facts which would be of importance, have a hearing, get a decision and then act on a dividend.

It is recommended that a company be given the right of appeal from such a notification and that the time limit for actual distribution of a dividend under subsection (8) run from the final determination of the appeal.

Income from Office or Employment — Section 5

The principle enunciated in section 5 is unjust, particularly in view of the privilege accorded to the running trades. In a complex industrial and social community such as Canada there are countless methods of gaining a livelihood and as a matter of simple justice a taxpayer ought to be subject to taxation only on the income which he receives clear after payment of all expenses necessarily incurred in the earning of it. It is difficult to see why any distinction should be made in this respect between persons employed on salary and those who receive fees or profits or the like.

It is submitted that the principle adopted in England (under Schedule E, Rule 9, of the British Income Tax Act), Australia, South Africa and New Zealand might well be followed in this country. Under the British Act, the holder of an office or employment who expends money wholly, exclusively and necessarily in the performance of his duties, may deduct such expenses in the computation of his income.

It is recommended that the Income Tax Act be amended to permit the deduction of such expenses.

Remuneration Paid to Spouse of a Proprietor or a Partner — Section 21(2), (3) and (4)

The provisions of the Act relating to the remuneration paid to the spouse of a proprietor of a business or a partner will result in inequitable taxation in countless deserving cases, particularly since section 12(2) of the Act would appear to provide adequate protection for the revenue.

A possible solution to this whole problem of the income of a spouse from a business, partnership or other source may be found in the principle of splitting the incomes of husband and wife (as in the United States).

It is recommended that section 21(2), (3) and (4) be deleted from the Act.

Losses by a Corporation in another Country — Section 20

Under this provision a Canadian company cannot deduct a foreign loss from Canadian income if it has at any time claimed a deduction for tax paid to the government of such country. The principle of carrying back and carrying forward business losses for taxation purposes is now fairly generally recognized in other countries as well as Canada. A Canadian company may thus be taxed on foreign losses because it cannot apply the loss against Canadian income whilst in the foreign country the loss may be carried forward or backward to reduce the tax paid in that country and thus the tax credit that could be claimed in Canada.

It is recommended that section 20 be deleted from the Act.

Limitation on Deduction to Spouse by reason of Receipt of Exempt Income — Sections 25(2)(a), (b) and 127(1)(n)

A limitation upon the deduction allowed to one spouse by reason of the receipt of income *including exempt income* by the other spouse is inequitable. For example, why should the receipt of exempt income by a taxpayer's wife have the effect of increasing the tax payable by the husband (which it does by reducing his exemption) when it would not do so if he were to receive the exempt income himself?

The definition of exempt income under section 127(1)(n) is wide enough to include receipts which are capital receipts and not income under the old Act. Since the definition includes amounts received by a taxpayer which are "by reason of any provision in Part I not included in computing his income" it would seem that the whole of the amount received by the spouse of a taxpayer in redemption of a war savings certificate would constitute exempt income.

It is recommended that the words "plus exempt income other than" be deleted from section 25(2)(a) and (b), and the words "other than exempt income and" substituted therefor.

Trusts or Estates — Section 60(2)

Section 60(2) perpetuates the policy of taxing payments for the maintenance of trust property even though they be made out of capital. This provision should be confined to payments made out of the income of the trust or estate, as in the case of subsection (1), which would be in harmony with the general recommendations of the Ives Commission regarding the taxation of annuities out of estates and trusts and otherwise. In any event it would not be difficult for a person aware of the effect of this subsection so to arrange his affairs as to avoid tax on such payments out of capital. Subsection (1) of section 60 appears to be wide enough to cover maintenance payments out of the income of the trust or estate.

It is recommended that section 60(2) be deleted from the Act.

Penalty for Failure to File Information Returns — Section 117

The penalty imposed by section 117 seems to be unnecessarily severe for failure to file the returns required by section 112(2). This is the employee's return to his employer claiming exemption for dependents and marital status in connection with withholding from his salary or wages. There is already a penalty for this in section 112(3) and, in any event, if the employee does not complete the form, tax is deducted on the basis of a single person so that the tax deductions are greater than would otherwise be the case.

It is recommended that section 117 be amended by deleting the reference to section 112(2).

Medical Expenses — Section 26(b)(v)

It is recommended that section 26(b)(v) be amended by adding the phrase, "or mentally incapacitated", after the word "blind".

Binding Effect of Assessment — Section 42(6)

Section 42(6) provides that an assessment shall be valid and binding notwithstanding any proceedings other than an appeal or an objection thereto. It is believed that provision should be made in this section for a re-opening of assessments where retroactive legislation is enacted. It is also thought that this provision might better be placed under the Division of the statute dealing with appeals.

It is recommended that this section be amended to provide the taxpayer with the right to be re-assessed where subsequent legislation confers on him a retroactive tax benefit.

Past Service Contributions to Superannuation Funds — Section 69

This section provides for the deduction in computing income of special payments on account of employees' superannuation or pension funds. However, it does not appear to cover adequately cases in which the payments are made over a period of more than ten years. There seems to be no reason why such an allowance should not be continued.

It is recommended that this section be amended to provide for the deduction of payments spread over a period of more than ten years in addition to those made in a lump sum or over a ten year period.

Contents of Notice of Assessment

It is recommended that the Act should provide that assessment notices contain full particulars of those matters wherein the assessment differs from the return filed, of the payments applied to the tax, of the interest payable, and of the procedure for filing objection and appeal.

APPENDIX A

Inventory Valuation — Section 14(2)

For many years the efforts of accountants have been directed towards the delineation of the most suitable methods of ascertaining profits and there is now general agreement that the profit is the excess of revenues over all costs properly allocable thereagainst. The real purpose of inventory valuation is to arrive at a proper matching of costs against revenues. While the items going to make up the inventory are those which are valued, the purpose of such valuation is to determine the costs which will be carried forward to be matched against the revenues of future periods. The value so arrived at permits the calculation of the costs to be matched against the revenues of the current period.

In order to meet the needs of sound business management the accounting profession, particularly in the English-speaking world, has endeavoured to develop principles which will assist in the fair and correct recording of business transactions. One of the principles earliest developed was that the accounting recognition of a transaction should be based on cost. In conformity with this general rule, the basic guide in the valuation of inventories may be said to be "cost", as hereinafter defined.

The "cost" of the items in an inventory is the total of the various charges that have been incurred in placing the material on its location in its present condition.

In this connection it is to be noted that the charges so incurred by a merchandising concern are naturally somewhat different from those incurred by a manufacturing company. In the case of the merchandising concern, "cost" may be said to be *laid down* cost, *i.e.*, invoice cost plus customs and excise duties, sales taxes, freight and other shipping charges, cartage charges and, in the case of goods which by their nature have to be stored for a significant period of time, a proportionate share of the warehousing expense. In the case of a manufacturing concern, "cost" of the raw materials will be the *laid down* cost and the "cost" of goods in process and finished goods will be the prime cost, *i.e.*, the cost of materials and labour, plus the proportionate share of the general administrative and overhead expense that is properly chargeable to production.

In some manufacturing organizations where the accounting system is sufficiently extensive, costs may be calculated on a "standard cost" basis. "Standard costs" are carefully estimated costs usually established as a result of scientific fact finding and represent the costs which it is estimated will be incurred under a properly planned method of manufacturing a product. If the variances between standard costs and actual costs under normal conditions are not significant in relation to the total, it is permissible in accordance with accepted accounting principles to use standard costs in place of actual costs in recording the valuation of inventories.

Since the number of items remaining in an inventory at the end of a year is less than the aggregate of those in the inventory at the beginning of the year and those acquired during the year the costs applicable to the remaining items is only part of the whole of the costs incurred during the year together with those carried forward from previous years. In determining the cost applicable to these remaining items several methods have gained recognition and may be said to be generally accepted:

(a) *Specific item cost.* Where the items under consideration are of such a nature and value as to be practicably capable of individual identification and where such a procedure would most clearly reflect the income, the cost of the items remaining in the inventory should be determined as the sum of the laid-down, manufactured or standard costs of the individual items making up the inventory.

(b) *FIFO (First In, First Out).* In this case the cost of the goods remaining at the end of year is determined on the assumption that the first costs assumed are the first costs to be cleared by charges against revenues, or, in other words, for the purposes of income determination it is assumed that the first goods purchased or acquired are the first goods sold. Therefore, in allocating the costs to the inventory on hand at the end of the year it is assumed that the goods on hand are those most recently acquired.

(c) *Average.* In this case the value given to an item in the inventory is the average of value given to such an item at the beginning of the period and the costs of such items acquired during the period. The costs cleared by a charge against revenues are calculated on the basis of the averages so arrived at for the various items making up the inventory. The average may be calculated in a number of different ways such as a straight arithmetic average, a weighted average or a moving average, depending upon the circumstances prevailing in any particular business.

(d) *LIFO* (*Last In, First Out*). In this case the cost of the goods remaining at the end of the year is determined on the assumption that the most recently assumed costs are the first costs to be cleared by a charge to revenues, or, in other words, for the purpose of income determination it is assumed that the last goods purchased or acquired are the first goods sold. Therefore, in allocating the costs to the inventory on hand at the end of the year it is assumed that the goods on hand are those first acquired.

In the determination of income it has long been recognized that under certain circumstances it is necessary to reduce the "cost" figure to a lower level, commonly known as "market". This recognizes the lowered usefulness of the inventory, from the standpoint of its revenue producing potentialities, and adjusts its valuation in line with this lowered usefulness.

The decline in usefulness may be brought about by a number of factors over which the particular concern usually has no control, such as obsolescence, falling price levels or damage or soiling of the goods by potential customers. The underlying assumption is that competition will force the prospective seller of such goods to reduce his selling price because they have a lowered usefulness to potential buyers, thus bringing about a decline in their revenue producing potential. Because of competitive conditions "market" may be taken as a reasonable measurement of the remaining usefulness of the items and therefore as a reasonable means of measuring the amount of the decline.

In the determination of the income known losses of this nature must be taken into account if the income for the period is to be correctly stated.

The term "market" has not acquired a meaning that, in this particular context, can be said to be universally accepted. By some, "market" is taken to mean the reproduction or replacement cost of the item or the equivalent cost that would have to be assumed to replace the item at a particular point of time. By others "market" is taken to mean the amount that can be realized from the sale of the article after taking into account the costs of selling and those necessary to put the item in condition to be sold and taking into account all conditions at the time of valuation which would affect the amount obtainable upon realization. The latter view has been approved by the Institute of Chartered Accountants in England and Wales, while the former view, with important modifications, has been taken by the Committee on Accounting Procedure of the American Institute of Accountants.

The usual practice in Canada is to regard "market" as being the estimated realizable value less the gross profit margin which would be realized under normal conditions.

If "market" is less than "cost" in any instance, the effect of reducing the valuation from "cost" to "market" is to recognize the loss sustained and to enable the business to look forward to a normal profit in the succeeding period when the items are sold.

Since goods are purchased or manufactured with the intention that they shall be sold at a profit, it appears that the most logical definition of "market" is one which relates the calculation to the purpose for which the goods are held. It is suggested, therefore, that the term "market" be defined as meaning:

> "the estimated amount which may be realized from the sale of the item or items less the gross profit margin which would be realized under normal conditions. (In estimating the probable realizable value, general business conditions, the state of the particular market upon which the goods will normally be sold and all other relevant factors must be taken into consideration.)"

It was stated above that the manufactured cost should be taken to mean the prime cost plus the proportion of general and administrative expenses properly chargeable to production. While as a general rule this is correct, in many instances taxpayers have consistently followed the practice of charging only a part or perhaps none of such expenses to inventory. If such practice has been followed in the past, the same procedure may properly be followed in the future, provided it is consistently applied and providing it results in a reasonably fair determination of profits.

The foregoing statement is applicable in the majority of cases but there are a number of prominent exceptions, of which the following are examples:

(a) In some instances valuation at "cost" may be adopted in respect of work-in-process inventories regardless of "market". This procedure is applicable where goods are manufactured for a specific order and where conditions surrounding the order are such that the arranged price will be secured regardless of changes in price levels or "market". This method is often followed in the job-printing trade in respect of work-in-process inventories.

(b) Valuation at selling price or selling price less definite costs of selling may properly be adopted where it is not possible to determine the cost of the items in the inventory and where there exists a recognized market and market price for the commodities. This method of inventory valuation is applicable in basic industries such as agriculture and mining.

(c) In some instances the retail store method of inventory valuation may properly be adopted. This method was developed essentially as a means of stock control but, because of its effectiveness, it has gained wide acceptance among merchandising establishments in addition to department stores where the idea originated. Where such a method of inventory valuation is followed consistently it provides a figure for the valuation of inventories which is reasonable for the measurement of periodic income.

The principal considerations in the determination of the method of inventory valuation to be adopted by any particular enterprise are (1) that the method clearly reflect the income of that enterprise, and (2) that such method be followed as long as it provides a fair measurement of profits.