THE WORK OF THE BOARD OF REFEREES UNDER
THE EXCESS PROFITS TAX ACT, 1940 *

I am to address you for a few minutes in respect to the
work of the Board of Referees under The Excess Profits Tax
Act, 1940. I am not here to discuss the merits of the Act or
its demerits, if any; these are matters for the consideration
of our legislators in the Parliament of Canada.

I have read Lord Hewart's "New Despotism" and, like all
lawyers, find myself very much in agreement with him in his
objections to the encroachments of bureaucracy upon the
functions of the courts. Now, owing to the exigency of war,
I find myself caught up and serving on one of the numerous
administrative bodies created to assist the Government in its
increasing control of our business and economic life. I shall
have a word to say upon this matter of administrative law in
general and the position of the Board of Referees in reference
to the courts at the end of this paper. But first of all I wish
to give a short explanation of the purpose and effect of The
Excess Profits Tax Act.

Excess Profits Tax Acts in General: Underlying the enact-
ment of excess profits taxes are the assumptions that, in wartime,
business profits will increase, that government revenue needs
will grow, and that the public will demand that the profits
—whether fortuitous or excessive—and whether or not arising
directly out of contracts for munitions—should be taken out
of war. Before any excess profits tax act can be written, there
has to be a clear-cut decision as to exactly what profits are to
be specially taxed.

Approaches to Excess Profits Taxation: One approach is
that any increase in profits in wartime should be specially taxed.
The other is that all profits in excess of specified rates of return on
capital should be progressively taxed. The differences between
these two approaches are fundamental.

One, which we may term the average earnings basis, is
founded on previous earning power. It simply assumes that
the pre-war profits were a reasonable criterion of earning power,
irrespective of the rate of return that was earned on the capital
employed, and that any wartime increase or excess above the
pre-war profits should be heavily taxed.

* An address delivered by the Honourable Mr. Justice Harrison, before
the Ontario section of the Canadian Bar Association, at Toronto, February
21, 1942.
The other method, the invested capital basis, fixes a basic rate of return on capital which is deemed socially fair and taxes all profits over such rate progressively. It differs from the average earnings basis, which recognizes that rates of return on capital employed in business are rarely uniform but reflect the difference in investment risks, management factors, capital structures, economic environment and a host of other influences which make a uniform rate of return upon capital entirely unfair and discriminatory.

**Canadian Excess Profits Tax Legislation:*** In Canada the choice of the average earnings base has now been made and the standard profit is the average earnings in the years 1936 to 1939. The invested capital basis has, however, been retained to establish certain limitations upon the Standard Profits which may be awarded to depressed taxpayers. The minimum award is 5% and the maximum award—10% upon the employed capital. The present E.P.T. Act is applicable to sole proprietorships, partnerships and corporations, subject to certain exemptions, but my references will be confined entirely to its incidence upon individual corporations.

The Act levies a tax of 75% on the calendar year profits, earned on and after January 1, 1940, which were in excess of the average annual profits in the calendar years 1936–9 less a deduction for the ordinary 18% corporation tax. It is provided, however, that if this tax amounts to less than 22% of the total profits, the greater tax of 22% will be imposed.

In effect a Canadian corporation is subject to the greater tax of 22% on total profits or a net tax of 61 1/2% on profits in excess of those earned in the Standard Period. Adding the 18% ordinary income tax, the total tax rate can vary between a minimum of 40% and a near maximum of 79 1/2% with a high rate of progression to the upper level as excess profits grow.

**Functions of the Board of Referees:** The Excess Profits Tax Act had to be written on the assumption that there was uniformity in business experience in 1936–9 and that the average annual profits in that period were a fair gauge of pre-war earning power. It is a matter of common observation, however, that the recovery from depression was not uniform even among members of the same industry. For some depressed cases the statutory provision of a $5,000 minimum of Standard Profits was adequate to assure a just base. For others the exclusion of a loss year or the abnormally low profits of one
year in calculating the standard was sufficient. Where neither of these provisions met the need, the Board of Referees was empowered to recommend the raising of the actual Standard Profits to a level which would correct or at least compensate in part for their special disabilities.

The Board of Referees has been appointed to deal with situations where no record of Standard Profits is available or where they were so low that it would not be just to tax the resulting excess without providing some relief. In other words, the Board has to set Standard Profits for new businesses and for depressed businesses.

**Eligibility of Standard Profit Claims:** The decision whether a business is new or depressed rests primarily with the Minister of National Revenue. The claims from established businesses that come before the Board of Referees are those where the Minister is not satisfied that the business of the taxpayer was depressed or is not satisfied that the Standard Profits claimed are fair and reasonable. All new businesses, *i.e.*, businesses started after December 31, 1937, must go to the Board of Referees to have their Standard Profits ascertained.

**Right of Taxpayer to be Heard by the Board of Referees:** Just herein an interesting legal question arises as to the right of a taxpayer to come before the Board. You will note that section 5—the operative section in respect to the Board of Referees—provides that a taxpayer who is convinced that his Standard Profits, ascertained in the ordinary way, are so low that it would not be just to determine his liability to the tax by reference thereto, may compute his own Standard Profits at such amount as he thinks just, but not exceeding an amount equal to interest at 10% per annum on his employed capital. His claim then goes before the Minister and, according to the express wording of the Act, the Minister has two alternatives—he may agree with the computation of the taxpayer or, if he is not satisfied that the taxpayer was depressed or if he is not satisfied that the Standard Profits as computed by the taxpayer are fair and reasonable, he "may" direct that the Standard Profits be ascertained by the Board of Referees. Those are the only express provisions in the Act.

It has been suggested that when imposing a duty upon a Minister of the Crown it is not proper to use the word "shall" and that the word "may", in appropriate cases, can always be interpreted as imperative or mandatory. As you know, there are numerous authorities upon this matter—in particular
the case of *Julius v. The Bishop of Exford*, 5 App. Cas. 214, wherein it is stated: "When a Statute confers an authority to do a judicial act in a certain case it is imperative on those so authorized to exercise the authority when the case arises and its exercise is duly applied for by a party interested and having the right to make the application." It could be said that the act of the Minister in referring a claim to the Board of Referees is judicial since the Board acts judicially and their recommendation becomes the act of the Minister by his approval. Other cases dealing with the matter are *Fonseca v. Schultz*, 7 Man. R. 458, and in *Re North Huron Election*, 58 O.L.R. 197. In *Supervisors v. U.S.*, 71 U.S. 435, decided by the Supreme Court of the United States it is stated: "Whenever public interest or individual rights call for the exercise of power given to public officers the language used, though permissive in form is, in fact, peremptory. What they are empowered to do for a third person, the law requires shall be done. The power is given not for their benefit but for his".

As to New Companies: Our duties in respect to new companies are specifically laid down in subsection two of section 5 of the Act, namely to ascertain the Standard Profits at such an amount as the Board thinks just, being an amount equal to a return on the capital employed of the applicant "at the rate earned by taxpayers during the Standard Period in similar circumstances engaged in the same or an analogous class of business." In reference to new companies it is further of interest to note that any company which increases its capital to the extent of $2\frac{1}{2}$% after the beginning of its last fiscal period in the Standard Period and also issues capital stock for such increase may apply as a new company and have its profits ascertained by the Board of Referees in the same way as other new companies, namely at the rate of return on capital earned by companies in the same business in the Standard Period,—such companies, however, to be selected by the Board of Referees in their sole discretion and their rate of return adjusted, if necessary, to insure "similar circumstances" for the taxpayers selected and so get a comparison of like with like. In the case of new companies the limitation of 10% on capital does not apply.

*Depressed Companies:* The second class of cases dealt with by the Board is that of taxpayers who claim their business was depressed in the Standard Period.
What Does Depression Mean: In the first place the Board considers that, generally speaking and with few exceptions, any business which did not earn 5% on its employed capital during the Standard Period was depressed. This we think is a fair implication from the provisions that all depressed taxpayers are entitled to a minimum award of 5% upon their capital. There may be certain types of companies which never have earned and never contemplate earning as much as 5% upon their capital. In such a case the Board is expressly given the power to leave the taxpayer with his own average yearly profits. What we cannot do is to award any amount less than 5%, if we desire to award a different rate from that actually earned by the taxpayer. But how are we to measure the depression of a particular company? Various measures of depression could be taken. For example, one business man might consider himself depressed if his average net profits in 1936-9 were less than in the boom year of 1929. Thus prior performance would be the test of depression. Another might contend that he was depressed if he failed to net as much as his competitor. In this case comparative performance would be the test. Still another might feel he was depressed if he did not net his customary 5% on sales. This would be an inherent or absolute test.

It became evident very early that the Board would be confronted with a wide variety of claims and that a study of profits behaviour and earnings rates in various industries might produce some helpful conclusions. The Board, therefore, had a large number of statistical studies made.

It is beyond the scope of my remarks to-day even to outline the results of the researches into business results from 1925 to 1939. They have not given the Board any generalized rules of thumb which can be universally applied to the claims coming before it. On the other hand they have provided a helpful and fairly lengthy record of business experience and have emphasized the differences, rather than the similarities, in the individual businesses which constitute an industry,—a fact which is frequently overlooked.

Our studies failed to provide any single simple test for depression and they provided no general mathematical formula for ascertaining Standard Profits. What they did do was to indicate the limitations of generalizations when applied to business and to lead to the conclusion that the administration of the Excess Profits Tax Act would best be served by considering each claim on its own merits rather than as part of a uniform industry.
The Act suggested a comparative test and recourse to the earnings of competitors as a basis for judgment. In this connection the Board has more than one alternative. The test need not necessarily be whether the applicant company earned the same rate on capital as its competitors. The more accurate test would be as to whether the applicant’s position relative to his competitors in the matter of earnings over a period of years had deteriorated in the Standard Period.

The Board has come to the opinion that no uniform rate of return upon capital can be ascertained for any industry which would do justice to the diversified circumstances of all members of such industry.

Ascertaining Standard Profits: The aim of the Board is to give to each applicant a rate of Standard Profits which he might have earned during the Standard Period had he not suffered from special disabilities, whether those disabilities were common to the industry in which he was engaged or peculiar to himself, and provided that those disabilities could not be considered permanent disabilities. In arriving at the rate for the individual companies the individual experience of the company is the chief factor in determining the Standard Profits.

Some questions to be considered are:—What did the company earn during the prosperous period of its business? What percentage of the profits earned in the prosperous period should the company be expected to have earned in the Standard Period?

While the Board tries to estimate the earnings which the company would have earned in the Standard Period if special disabilities were removed, there are some considerations, often put forward, which, while important to the owners of the business appear to have little, if any, relevance in ascertaining Standard Profits under the Act. For instance:

1. The claim to recoup out of profits the amounts necessary to compensate for past lean years and possible future lean years. (The Board does have regard to the fact that some types of business are extra hazardous and may be classed as “Feast and Famine” businesses.)
2. The claim that certain types of business are entitled to a certain rate of return regardless of past earning experience.
3. The claim for increased Standard Profits because heavy borrowings or heavy inventories make it difficult to raise money to pay taxes.
4. The claim to have sufficient profit, after taxes, to pay fixed or customary dividends or debt repayment obligations.

In hearings which are conducted each week the Board discusses claims with taxpayers and, in the light of their representations and the Board’s own experience and judgment, endeavours to reach a conclusion as to a fair and reasonable base for the calculation of excess profits.

Section 5(3) where Capital Standard not Applicable: The most difficult provision to administer is section 5(3), added during the 1941 Session of Parliament. That subsection was inserted to enable the Board to award a Standard Profit where a Standard Profit limited to a certain return upon capital would not do justice. There are three classes of companies which can be dealt with under this provision, namely:

1. Companies carrying on a business of a personal service nature where capital is not an important factor.

2. Companies, the capital of which through losses has become abnormally impaired, so that the limitation of 10% upon the actual capital left would be far below the actual earning power of the company.

3. Companies of which the capital employed due to extraordinary circumstances is abnormally low.

Just a word or two regarding these three classes. In the first place as to companies where capital is not an important factor.

Capital is defined in the Act as equity capital i.e., assets less liabilities—but in this section there is strong ground for argument that the context requires a broad meaning for the word “capital.” The businesses intended to be covered are those like fire insurance, brokers, real estate agents, and other service types of business where it is apparent that no plant is necessary in order to carry on the business nor any considerable amount of working capital. In businesses of that kind, to limit the Standard Profit to 10% of the capital would not be realistic. In such cases the Board looks at the earning power of such taxpayers in their profitable period as compared with the Standard Period.

The second class of company is that where capital has become impaired. There are companies which have no equity capital—their liabilities together with the depreciation as calculated by the Income Tax Department exceed their assets.
Obviously no capital standard is possible. In such case, again, the Board looks at earning power.

As to the third class, where capital is abnormally low, one test which may be applied is to compare the capital employed with that of other companies engaged in the same kind of business. If the ratio of capital to the gross sales or turnover in the case of the applicant is very much less than that of others engaged in the same business, there is ground for a finding that the capital is abnormally low.

Unless section 5(3) is rigidly administered it can be abused, and the Board has been loath to consider claims under it unless they conformed to the strict requirements of the subsection and unless they could not be justly and realistically treated under section 5(1). The Board has not endeavoured to classify rigidly those businesses in which capital is not a material factor in the earning of profits nor has it attempted to define abnormal impairment of capital or abnormally low capital due to extraordinary circumstances.

In determining conditions for eligibility under section 5(3) the Board has insisted that lowness of capital is a primary requirement. Unless this condition is met, representations that disposition of the claim under section 5(1) "would result in the imposition of excessive taxation amounting to unjustifiable hardship or extreme discrimination or would jeopardize the continuation of the business of the taxpayer", have not been considered adequate per se to make a claim eligible under section 5(3).

In ascertaining Standard Profits under section 5(3) the Board has followed as far as possible the procedure adopted in the administration of the other sections. On the basis of the facts presented in individual claims it has attempted to make realistic awards, having regard to the general limitations in the Act.

Regarding the position of the Board of Referees in relation to the courts, our work is a part of what has been termed Administrative Law. The principal objections to Administrative Boards in general are:

1. That decisions affecting rights or liabilities of subjects are made by unidentified Department officials who have no responsibility except to official superiors.

This cannot be said of the Board of Referees. We are not Department officials, but an entirely independent body who
receive no instructions from the Government or any Minister as to the use of our powers under the Act.

2. That there is no oral hearing and no opportunity for parties to put forward their case.

As to this point, every taxpayer, whose claim has been referred to the Board, is given an opportunity of presenting his claim before the Board. Moreover the applicant can bring with him his legal adviser, his accountant or anyone else to assist him. The Board employs no counsel, as the hearing is essentially a factual one, but the Board is ready to listen to all arguments that may be made either upon the principles applicable to the claim or the interpretation of the Act.

3. That proceedings are not held in public.

As to that, the lack of publicity of the hearing is entirely for the protection of the applicant, who, in order to make his claim, must disclose the particulars of his business and it is his privilege to keep the details of his business from the public and to be assured that his communications to the Board will be considered as confidential as his income tax return.

It is provided that when the Minister approves the recommendations of the Board his decisions are final and conclusive. Large powers of discretion are given to the Board. This means that any finding based on discretion cannot be challenged in the courts.

The reasons for the existence of such a Board are mainly that the actual awards made must in the nature of things be largely discretionary and are not capable of being dealt with, except in a very broad way, upon any fixed and rigid rules. The decisions are not such as a legal tribunal is qualified to make. A court administers law according to certain defined principles and is not asked to make discretionary awards—that is properly an administrative function—and since no Minister can personally deal with all such problems it is a reasonable solution that he should be assisted by some body specially charged with such work. The position of Boards such as the Board of Referees has been discussed in several cases both in the House of Lords and in the Judicial Committee. Thus in Board of Education v. Rice, [1911] A.C. 179, Lord Loreburn stated that the Board of Education in making its decisions must act in good faith and fairly listen to both sides. In Local Government Board v. Arlidge, [1915] A.C. 120, Lord Shaw said "That the judiciary
should presume to impose its own methods on administrative or executive officers is a usurpation.” In that case Arlidge’s house was ordered to be torn down and on appeal to the Local Government Board Arlidge was refused the opportunity of seeing the report which the Inspector, after an enquiry, had made to the Board, and was not heard on the appeal, though he did have the opportunity of appearing and stating his case at the public enquiry held by the Inspector. Viscount Haldane said of the Board: “When Parliament entrusts it with judicial duties, Parliament must be taken, in the absence of any declaration to the contrary, to have intended it to follow the procedure which is its own, and is necessary if it is to be capable of doing its work efficiently.”

An examination of the authorities shows, however, that there are certain limitations upon the powers of all administrative tribunals.

1. They must keep within the confines of the statutes creating them.

2. They must observe natural justice, meaning thereby —honest decisions made after hearing the parties.

3. They must have some relevant evidence on which to base their decisions.

There are also two other important limiting factors, namely: Public opinion and the power of the Legislature. Finally there is the limitation self-imposed by the personnel of the Board. Lord Hewart himself said in *Rex v. Minister of Health*, [1925] 2 K.B. 363. “Local authorities are vested with great powers because in practice they show themselves to be worthy of them and their discretion is not lightly to be diminished in any degree whatsoever.”

The decisions of the Board of Referees are almost entirely decisions involving matters of discretion. There is seldom any dispute as to the facts, which are ascertained from the taxpayer’s own income tax returns plus statements made in his application or before the Board.

Again, all decisions made by the Board of Referees either leave the taxpayer under the general provisions of the Act, with its maximum and minimum provisions or, if any change is made in his position, it is a change by way of improving that position. The Board thus does harm to no one—the only objection there can be to the Board’s decisions is that they
do not give as much improvement as the taxpayer would like. Essentially, therefore, the Board is a benefit-conferring body.

In conclusion I would say that the Board considers its duty, subject only to the limits expressed in the Act, to be the equalization of the base of taxation so that all taxpayers may feel that their Standard Profits represent an amount that was actually earned or could have been earned in 1936-9. The resulting rate of total taxation—whether it is 40% or 79½%—is a consequence of the acceleration of profits in wartime. It is obvious that these consequences cannot be equalized by setting a uniform tax rate and, even though the consequences might in the long run turn out to be undesirable, the effect and intent of the law is clearly to levy taxes at a higher rate as profits increase.

For the most part the Board excludes references to wartime profits as a criterion of earning power in the Standard Period. It is willing to examine the record up to the end of 1939 but not beyond, whenever it can be avoided. Likewise, it has resisted all claims for sliding scale or variable Standard Profits which would rise and fall with production or profits. Its recommendations of Standard Profits when approved by the Minister are fixed and invariable for the duration of the Act.

The Board considers that it is fulfilling its duty and is acting on logical and legal grounds when it uses its best efforts to make sure that a claimant is neither better nor worse off, as far as his tax base is concerned, than the majority of taxpayers who must rely upon their actual Standard Profits in the years 1936-9 as their base.

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