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THE WAR CONTRACTS DEPRECIATION BOARD*

Jurisdiction

Prior to the passing of Order-in-Council 4217, dated August 27th, 1940, the depreciation on depreciable capital assets to which a tax-payer was entitled was governed by section 6 of the Income War Tax Act, which provides that "in computing the amount of profits or gains to be assessed a deduction shall not be allowed in respect of (*n*) depreciation, except such an 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." Obviously the section gives to the Minister fairly broad jurisdiction through a discretion to be exercised judicially, both in the ordinary case applied to all classes and kinds of industry, and in the special case where plant and equipment are built or acquired to fulfil orders for war purposes. It must be noted, however, that under the statute his jurisdiction as to special depreciation is limited to plant and equipment built or acquired to fulfil orders for war purposes, and does not extend beyond that. Under well and long-recognized income tax law procedure, land is not a depreciable asset, nor are good-will, patent rights, inventory proper, nor inventory and stores such as spare parts. These fundamental principles are laid down so as to help an understanding of the work of the Board under its Order-in-Council.

By the middle of the year 1940 it became quite evident that industry in Canada had to be expanded to a production for war purposes never even imagined before. To accomplish this two methods could be employed: either the Government could furnish the necessary capital or industry could furnish it, if allowed to deduct its capital expenditures from taxable income

* The present article is a resumé of an address delivered before the Ontario section of the Canadian Bar Association in January last.

by way of depreciation out of its war profits. The first Excess Profits Tax Act had been passed in the year 1939. Industry was naturally hesitant about advancing capital for fulfilling war contracts unless, in the words of the Order-in-Council, it was "reasonably assured that an allowance in respect of depreciable assets, acquired or constructed for war purposes, will be allowed by way of special depreciation when determining income tax liability." To provide that reasonable assurance an independent Board was set up, composed of a representative of the Department of Munitions and Supply, a representative of the Income Tax Department, and an independent Chairman.

It must be kept in mind that the functions of the Board are strictly delimited by its Order-in-Council. Its jurisdiction does not extend as far as that of the Minister of National Revenue under section (*n*) of The Income War Tax Act, since it cannot give relief in the case of capital expenditures undertaken prior to September 9th, 1939, the date of Canada's declaration of war. Like the Minister, its jurisdiction is limited to depreciable assets in the accepted accounting sense, and, as in the case of the Minister, the applicant must fall into the category of those fulfilling orders for war purposes. The Order-in-Council is passed under The War Measures Act, and therefore the Board's certificate is probably binding on the Income Tax Department, but in form it is a recommendation to the Minister on the theory that in the case of war industry the Board is exercising, in effect, the discretion given to the Minister under section 6 (*n*) within the limits of its reference. This, in a sense, is a courteous fiction because, while the Board derives its jurisdiction under The War Measures Act, it is admonished by recital to have regard to the provisions of The Income War Tax Act and the Excess Profits Tax Act.

In order to qualify under the original Order-in-Council an applicant had to establish that he had a war contract, or subcontract within the meaning of the Order-in-Council. It was found that expansion was needed in many cases where the expansion had to antedate the war contract, and that, technically, the applicant could not properly qualify for the relief. Accordingly, a supplementary Order-in-Council was passed on the 4th December, 1940 (P.C. 7121), whereby the Board was authorized to recognize a certificate of necessity of the Minister or Deputy Minister of the Department of Munitions and Supply, as a war contract. This has obviated a good many of the earlier difficulties, although it must be kept in mind that such a certifi-

cate has only the effect of giving the Board jurisdiction. It does not insure the holder of relief, but merely places him on parity with the other contractor whose contract antedated his expenditure.

Procedure

The Board's procedure is made as simple as possible. It is presumed that industry is not going to be a party to fraud on the national treasury, and therefore such formalities as the swearing of witnesses are dispensed with, and the hearing consists of an informal round table discussion with the applicant as to his business problems, and as to the measure of relief to which he is entitled. Generally speaking, the decision is given promptly at the time of the hearing, and the formal certificate issued as soon thereafter as it can be prepared and signed by the Chairman and Secretary. As a rule the Board strongly prefers that in each case the applicant shall be heard, although it will decide the case in his absence if he forwards a formal waiver in writing of his right of appearing personally.

The Board as a whole sits formally for about two weeks of each month. The remainder of the month is taken up by its staff in getting the cases ready for hearing. Any delay in disposing of cases is usually the result of failure on the part of the applicant to furnish particulars so as to enable the Secretary to certify the case as ready for hearing. From the applicant's point of view the procedure here too is made as simple as possible. He simply writes the Secretary advising him of his application. The Board then sends him forms and a list of its requirements. The permanent staff then investigates his war contract position, his financial situation and, in general, all the facts which it considers relevant to a proper consideration of the claim. When the investigation is reasonably complete, and it frequently involves considerable correspondence and checking, the applicant is notified of a date for his hearing. At the hearing each member of the Board has before him a summary prepared in advance by the permanent staff, on the claim, and the matter is then finally disposed of.

Policy

Generally speaking, the period of write-off is determined by the delivery requirements under the known war contracts, with consideration given to the reasonable prospects of additional

contracts in connection with which the capital assets will be used. Also, it is, of course, postulated on the length of the war — more or less a pure speculative guess.

The Board is inclined to place a heavy onus on the applicant to establish reasonably that he is within the class intended to be benefited by the Order-in-Council. Once that has been established, the Board tries to conform reasonably to the wishes of the applicant as to the period of write-off, subject, of course, to the war contract position as to deliveries and prospective deliveries on future contracts. Generally speaking, the period is not less than two years, unless the capital asset has been acquired for a special war contract which requires deliveries to be made in less than a two-year period. As a general rule, the Board does not favour long write-offs unless the applicant desires them, because it considers that from the point of view of the national treasury, heavy depreciation is best absorbed in the periods of greatest production, greatest profits and highest taxes. After all, the capital asset can only be entitled to a complete write-off once, and if it remains in use after being written off, the Treasury then reaps the benefit in higher taxes and the Department of Munitions and Supply in lowered costs.

In each case the Board is charged with the obligation of estimating what is described in the Order-in-Council as the "post-war value of the capital asset." From the view-point of the Board, the expression "post-war value" is something of a misnomer. Rather, the Board takes the general broad view that it should try to determine what percentage of the expenditure should be subject to normal rates of depreciation, rather than special. Viewed this way, a number of factors may enter into consideration. For example, an applicant may be trying to build up a completely new plant by replacement of old machines at the expense of the national revenue. In the way the Board looks at the matter straight replacements do not represent *additional* expenditure for war purposes. Old machines have probably long been depreciated fully, and through this source the original capital has been recovered. The expenditure does not represent new capital at all, but is merely a shifting of the original capital in the business. Then again, there are cases of entirely new businesses opening up since the outbreak of war, and doing war work exclusively. Frequently these are prospective competitors in time of peace of existing businesses, who have to carry a good deal, or most of their capital at normal rates. In the Board's view it would be quite inequitable

to set up a new business and permit it to have the advantage of a fully written plant in competition with existing business not so favourably situated.

There are many problems of this kind and character which come up from time to time, which need not be enlarged on here, but which enter into consideration in determining what is called "post-war value." In the ordinary case the Board pretty well ignores the question of scrap value, preferring to base its ideas on the value in use to the particular applicant after the war period. Frequently cases come up where the applicant, who before the war occupied rented premises, now has acquired land and built his own new building. Manifestly, it would not be fair to permit a complete write-off at the expense of the national revenue; neither would it be fair to the competitor. The business must carry a reasonable portion of the expenditure at normal depreciation rates.

There have been cases as well where the applicant has attempted to utilize the powers of the Board as part of a promotion scheme. In other words, while he induces people to put money into a venture, it is on the assurance that the money will be recovered from anticipated profits by way of depreciation, and returned to the investor with a profit. In all cases where the evidence convinces the Board that its function is an integral part of a promotion scheme, it has refused to exercise its powers in favour of the applicant. Cases of this type occasionally involve fairly fine distinctions as to which is the real governing motive — the furtherance of the war effort, or the elimination of the risk which initial investment usually subjects itself to.

There was a period early in its activities when the Board gave assurances in writing as to what decision it would give when the expenditure was completed — this before any expenditure was made at all. Experience showed that, generally speaking, this was a most unsatisfactory process. Applicants seemed to think that it put into their hands a blank cheque to do anything. There have been cases where the applicant discussed with the Board the construction of a factory building, and when the expenditure later turned up completed and properly verified, it was found that an office building had been included as well, though never mentioned at the initial hearing. Then it was found as well that applicants were using letters of assurance to secure credit from the banks to finance the expenditure. The bank then found itself with an assurance of

a write-off in a fiscal year when the assets had not had any use, due to the fact that they had not been completed or installed. No depreciation can be granted until the assets come into use, and so the letter of assurance could not be implemented because the applicant had failed to comply with the conditions stipulated. Obviously, this created unsatisfactory situations as far as everybody connected with the transaction was concerned.

On review, the Board decided that this method should not be continued, although in the early period it may have had some merit in assisting to promote the war effort. Now, only in extraordinary cases will any definite assurance be given. Even at that it is extremely doubtful if the Board has any power under its Order-in-Council to give assurances. Certainly, the Order-in-Council does not specifically authorize assurances in advance. The only real assurance is that when the expenditure has been made, the Government has provided an independent Board to decide what measure of relief the applicant shall be entitled to in the circumstances.

There has been some criticism of the operation of the Board emanating from the American side, largely to the effect that it is impossible to determine scientifically post-war value in advance. That, of course, is admitted. However, scientific determination of something is frequently not relevant to policy. Under our system, which admittedly is postulated on a guess as to the duration of the war, and far from scientific, industry knows where it is at and can base its plans on a definite and final decision as far as the Board is concerned. That is one reason why, once a certificate has been granted, the Board refuses to review its decisions. It may be that the war will terminate sooner than anticipated, and that industry will be technically entitled to write-offs in a period when there will not be sufficient profits to absorb them, and therefore they will be a detriment rather than a benefit. If and when that time comes it will present a new problem to be solved by the Government, and not by the Board. In the meantime industry is proceeding according to definite plan, and for the time being knows where it stands. Industry and the Board together must exercise their own best judgment as to the duration of the war, in the hope that in as few cases as possible will there be any necessity for revision on account of the war coming to an abrupt end.

Obviously, expenditures made with Government money on buildings or machinery to which the Government retains title

do not come within the jurisdiction of the Board. However, there are cases where the Government finances the expenditure by way of loan, either secured or not secured. The question of repayment of the loan by industry naturally is closely connected with the depreciation allowed, the repayment being made with monies withheld from taxable income by way of depreciation allowance. In cases of this kind the Board deals with the problem in advance of the terms of repayment being embodied in the loan contract, so that in this way the special depreciation allowance is made to correspond reasonably with the repayments of the Government loan. There have been cases as well where the Government has made the expenditure and retained title, but where the applicant becomes desirous of purchasing the assets from the Government. In this type of case, once a transfer has been made and the assets in question are set up in the books of the Company, the Board is disposed to allow special depreciation to an amount sufficient to enable the applicant to pay out the Government investment. Sometimes this is a very desirable solution, not only from the applicant's, but from the Government's viewpoint as well. Sometimes it is not, particularly in cases where the special depreciation is taken in as part of the cost of the product.

Cases with which the Board has considerable difficulty in arriving at a conclusion are those where the applicant has acquired an industry already engaged in war manufacture. The question which arises is whether the purchaser is entitled to special depreciation on assets to which the vendor was not entitled under the Order-in-Council. In cases of this type the Board tries to use its best judgment in arriving at real motives and decides accordingly. It may be said that in the two or three cases which have come before the Board write-off has been refused, except in the case of assets acquired or installed by either vendor or purchaser since September 9th, 1939.

The Position of the Legal Profession in the Work of the Board

The Board has no restrictive rules with regard to those who may represent an applicant. He may be represented by counsel or his auditor, or by another industrialist, if he so chooses. As a rule auditors appear more frequently before the Board than lawyers. Obviously, the problem is always involved with accounting principles, and so it behooves any lawyer who wishes to represent a client before the Board, to be reasonably familiar with accounting principles, and especially to familiarize himself with his client's case from an accounting viewpoint.

In this connection it may be observed that until comparatively recently, the course in accounting offered by our law schools has been pretty sketchy. In view of the modern tendency to increase the number of bodies dealing with administrative law, and the growth in number and complexity of taxing statutes, lawyers coming into practice must be fortified, or fortify themselves, with a reasonably thorough knowledge of accounting, or else be prepared to surrender a lucrative field to others who are so qualified. One may sympathize with Lord Hewart's resentment at the encroachment that is taking place on the functions of the Court by the appointment of bodies to deal with what is called "administrative law", but the fact is these bodies are steadily coming more and more to the fore, and frequently without definitely encroaching on the functions of the Court in the strict sense. It, therefore, is incumbent on the legal profession to build its fences in accordance with obvious modern tendencies, and not be content simply to sit back and complain. These may be pretty general and broad statements in this particular context, because the War Contracts Depreciation Board is, after all, a body which will automatically disappear in due course, when the war is over. However, one who is by education and training a lawyer cannot sit on such a Board and in the midst of activities with which the work of the Board is intimately connected, without reflecting on the fact that for the legal profession a new day has dawned, and it must equip itself accordingly.

Conclusion

While the work of the Board is, in a sense, in a comparatively narrow legal and accounting field, it is dealing with very large sums of money. The amount involved it is not permitted to mention, but some idea can be roughly gained when it can be said that, at the time of writing, over eight hundred applications have been dealt with and disposed of since the Board's inception in September of 1940. From this it can also be inferred that Canadian war industry has done and is doing a remarkably fine job. The members of the Board are in a position to pay tribute to industry in this way with very little restraint. Occasionally the odd applicant seeks more than he finds he is entitled to, but generally speaking Canadian industry is making an all-out war effort. The Board has enjoyed its relationship with industry all the more because it has been left free and independent to deal with its problems completely

unhampered by Government interference or suggestion. The two departments most affected by the work of the Board, viz., the Department of Munitions and Supply and the Department of National Revenue have fully co-operated, so that in working out its problems it has been the province of the Board to deal with its business in a most satisfactory way — across the table from business executives who, as a rule, are doing their duty and performing their obligations in a big way.

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