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of the
ROYAL COMMISSION ON TAXATION

Number 21

CAPITAL COST ALLOWANCE

by

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Peat, Marwick, Mitchell & Company
London, Canada

August 1966

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Price \$2.75

Catalogue No. ZI-1962/1-1/21

Price subject to change without notice

ROGER DUHAMEL, F.R.S.C.
Queen's Printer and Controller of Stationery
Ottawa, Canada
1967

This is one of a series of studies that have been prepared for the Royal Commission on Taxation. Although these studies are published under the auspices of the Commission, this does not necessarily imply that the Commission agrees with the views expressed.

PREFACE

This study, which was prepared for the Royal Commission on Taxation during 1963 and 1964, represents the combined efforts of several members of the Tax Structure Studies Research Staff of the Commission. In particular, I would like to acknowledge the contributions of William F. Martin, A.E.J. Thompson, J. A. Coates, Michael Clay and Ronald J. Farano, all of whom furnished many ideas and a substantial amount of the material content.

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CHAPTER 1—INTRODUCTION

In its broadest sense, the consideration of capital cost allowances in a study on the taxation of business income would involve a review of the treatment of all forms of capital outlay—for land, buildings, equipment, goodwill, securities—that is to say, of all types of outlay except those whose benefit immediately expires, or when it is made for the acquisition of a trading asset. In the present study, consideration is given only to the treatment of those capital assets commonly referred to as "depreciable", that is, buildings, equipment, furniture and fixtures, automobiles and the like, and to three types of intangible assets—patents, franchises, and leasehold improvements. General consideration of what constitutes a capital outlay, and the treatment of other types of capital assets, are not dealt with in this study.

Depreciable assets are usually tangible capital assets which lose value over a period of time. It seems obvious that in any system of taxing business income recognition would have to be given to such loss in value; however, this has not always been the case. Originally, the loss in value arose primarily from physical wear and tear, but as technological changes became more rapid obsolescence emerged as an important factor.

In Canada, we have had two different systems of allowing for the depreciation of capital assets. From 1917 to 1948 there was a flexible system which depended upon ministerial discretion and which, in general, permitted a fair allowance which closely approximated that provided by businesses.

No deduction was permitted for losses on disposal of depreciable assets however, and this became increasingly serious as obsolescence became more prevalent. Furthermore, complexities of the system and public doubts as to the proper exercise of ministerial discretion eventually brought about a change.

The new system, which was introduced in 1949, has achieved its stated objectives—that of providing a simple system based on the rule of law which allows a deduction for the capital cost of depreciable assets. Because of its success in meeting these objectives, it is recommended that the present system be retained. The recommendations which are made herein relate only to modifications of the basic system, or to problems which would arise under any system.

That is not to say that the present system can be accepted without reservation. There is good evidence to suggest that it does not provide the best measurement of business income. For most taxpayers it provides an incentive in the form of tax deferment (through larger allowances in the early years) which may become a permanent tax saving. Justification for the system must rest to a great extent on an evaluation of this incentive feature, which is probably a necessary part of a system as simple as the present one, since the allowances involved must be on the generous side to avoid being inadequate under special circumstances.

1917 to 1948. From the inception of income tax in Canada in 1917 to the introduction of the Income Tax Act in 1949, depreciation was not fully recognized as an expense in that its deduction was allowed only at the discretion of the Minister. In practice, depreciation allowances were generally granted on the same basis as they were calculated in the

taxpayer's accounts, although the Department did develop a set of informal official rates. These rates were set for individual assets and the allowances were calculated on that basis; as a result, there developed a multitude of rates which became difficult to administer. Once rates were established for a taxpayer they had to be strictly adhered to except on the contrary direction of the Minister. In a loss year at least half of the usual allowances had to be claimed. The method of depreciation generally used was the straight-line method, a method which required spreading the cost of an asset evenly over its estimated useful life. This method required tax records showing the date of acquisition of assets so that assets would not be over-depreciated. No recognition was given to abnormal use until 1940 when extra depreciation allowances were allowed because of abnormal use during the war.

Profits or losses arising on the disposition of depreciable property were treated as capital gains or losses despite the fact that they usually resulted from inadequate depreciation rates. Once property was sold or scrapped, no further allowances could be claimed. This meant, in effect, that obsolescence was not recognized as a factor leading to a loss in value of depreciable property.

The system generally provided a good measure of depreciation in arriving at business income, but its main weaknesses were significant:

1. It did not recognize the taxpayers' positive right to a depreciation allowance.
2. By treating profits and losses on disposal as capital in nature it did not recognize the imprecise nature of any depreciation charge and, in particular, it did not recognize the unpredictable effects of obsolescence on the loss in value of depreciable property.

1949 to the Present. The depreciation system which was adopted in 1949 represented a substantial change in approach. Full recognition of depreciation as an expense was given by providing taxpayers with a positive right to an allowance in respect of depreciable assets. Full deduction for the loss in value of depreciable assets was assured through the introduction of provisions which enabled a loss on disposal to be recovered through subsequent allowances or by an immediate allowance. As a corollary to this change, any depreciation already claimed became subject to recapture if recovered upon sale of an asset. This complete recognition of capital costs incurred by a taxpayer probably explains why the phrase "capital cost allowance" rather than "depreciation" is used in referring to the new system. The new system is also simpler from the point of view of both the taxpayer and the Department.

The following are the basic features of the new system:

Classes of Assets. Depreciable property is broken down into several groups or classes depending upon the nature of the property acquired. The cost of all depreciable property included in one class is added together and a single rate is set for the class for purposes of calculating the maximum allowance which can be claimed as a tax deduction. By the grouping of property into a few classes the multitude of depreciation rates which were required under the old system was substantially reduced.

The grouping of assets also gave the Department a means of recognizing the profits or losses which inevitably arise on the disposition of property. Under the group method, it is assumed that a profit on disposal of one asset in the group will be offset by a loss on another. Thus, when a loss arises on disposal of an individual asset under the capital cost allowance system,

the proceeds are merely credited to the class and allowances may continue to be claimed on the undepreciated cost remaining. Likewise, when a profit arises, the proceeds up to the original capital cost of the asset are credited to the class, thereby reducing the undepreciated cost of the remaining assets in the class and reducing future allowances.

The only non-taxable amount which can arise is a gain which results from sale proceeds being in excess of original capital cost. The treatment of proceeds in excess of the undepreciated capital cost of the class, or undepreciated capital cost when no assets remain in the class, is described below.

Diminishing Balance Method. Instead of allowing several different methods of depreciation, the new system required that one method of depreciation be used in all but a few instances. That method is the diminishing balance method (also described as declining or reducing balance), under which the prescribed rates are applied to the balance of the cost not claimed in previous years. Unlike the straight-line method, the diminishing balance method does not require records to be kept for each asset showing the date of acquisition since it is impossible to claim more than the original cost. This method, when applied to groups of assets, was meant to simplify greatly the calculation of depreciation for both the Department and the taxpayer.

The rates of depreciation under the new system were also changed to accommodate the new method of depreciation. They were set, for most assets, at double the rates formerly allowed on the straight-line basis, thereby producing larger allowances in the early years, but lower allowances in later years. These rates were promulgated in Regulations issued pursuant to the Income Tax Act and consequently have the force of law.

Terminal Loss. Complete amortization of the cost of depreciable assets is assured through the terminal loss provision whereby the undepreciated capital cost of any class which has no assets remaining therein may be taken as a deduction in the year of disposal of the last remaining property in the class.

Recapture. Total allowances (of a class) are limited to the final proven cost of assets in the class to the taxpayer. We have already seen how the proceeds of disposal reduce the balance of cost in a class and, thereby, the future allowances to be claimed. The recapture provision takes back into income any proceeds which exceed the undepreciated capital cost remaining in the class. Thus, it is impossible for total deductions in respect of capital cost allowances to exceed the original cost of assets in the class.

Permissiveness. Unlike the original system, the present one does not require the taxpayer to take a deduction in respect of capital cost allowances in any taxation year. The taxpayer has the privilege of deferring all or any portion of the maximum deduction allowed in a taxation year. If deferred, it remains a part of the balance of undepreciated capital cost of the class (or classes) and the maximum allowance may then be recalculated on this balance (plus any additions and minus any proceeds) the following year.

Booking Requirement. When the present system was introduced in 1949 taxpayers were required to charge in their accounts the same amount of depreciation as they claimed for tax purposes. This requirement, embodied in Regulation 1100(4), was revoked for the 1954 and subsequent taxation years.

With the exception of the booking requirement, the basic features of the capital cost allowance system remain unchanged today.

Amortization of Cost. The objective of providing for the complete amortization of the proven cost of certain depreciable property has largely been attained through the terminal loss and recapture provisions, as well as through the grouping of assets wherein profits and losses realized on the disposal of fixed assets are offset against each other and the undepreciated capital cost of other property remaining in the class. No longer does the unrealistic situation arise wherein the disposal of property which has been over- or under-depreciated give rise to a non-taxable capital gain or loss.

With the grouping of depreciable assets into a relatively small number of classes, however, it is almost inevitable that the class rate will not be entirely appropriate for many taxpayers, and profits and losses on disposal of fixed assets in a class will therefore not average out. If the rate is slightly low, losses on disposal will be suffered, and the taxpayer will be allowed deductions for them only gradually. If the rate is too high, profits on disposal will be realized, and the Department will tax these only gradually through reduced allowances in the future.

In general, the rates provided have been generous and, consequently, it has been the Department rather than the taxpayer which has suffered through this aspect of the system. Some instances where rates have been inadequate for a particular taxpayer have come to our attention, however, and no doubt these situations will become more frequent the longer the group system is in effect.

Recapture and terminal loss provisions on an individual asset basis is the only perfect solution to the problems discussed above, but this

treatment would not be compatible with the taxpayers' and the government's desire for a system which is simple.

Simplicity. The combination of a compulsory reducing balance method of depreciation and the grouping of assets with a single maximum rate of depreciation for each class has made the capital cost allowance system simple and economical from the point of view of both the taxpayers and the Department of National Revenue. It is a disadvantage to those taxpayers who keep their depreciation accounts on a basis different from that required for tax purposes, but there has been little complaint in this regard, perhaps because the maintenance of duplicate records for tax purposes do not require much extra effort.

On the other hand, it should be noted that the majority of the anomalies and inequities which exist in the present system are a result of the quest for simplicity.

As a Measure of Business Income. Whether the present system is an appropriate method for measuring depreciation in arriving at business income is best gauged by comparing it with accepted accounting principles and practice. In general, the comparison indicates that the tax system is an acceptable one.

1. It is based on historic cost. While accountants recognize the problems of changing dollar values, satisfactory methods of reflecting them in financial statements have not yet been sufficiently developed for general adoption and there is no prospect of this taking place in the immediate future. Until such developments do take place, it would be unwise to change the basis recognized for tax purposes. In addition,

it should be noted that replacement cost depreciation would be inequitable for tax purposes since all taxpayers suffer from the effects of inflation. Although inequity is not a consideration in the measurement of business income, it is obviously significant to the determination of income tax liabilities.

2. The tax system allocates the cost of the depreciable asset over its life in a systematic and rational manner, the method used being one which is accepted for accounting purposes.
3. Since profits or losses on disposal are no longer treated as non-taxable or non-deductible, the tax system reflects the imprecise nature of depreciation and the ultimate accounting for the net capital cost of the assets.

There is, however, good evidence to suggest that the diminishing balance method has become widely adopted by business merely because of its use for tax purposes. Prior to 1949, it was rarely used. When it was introduced in 1949 there were protests concerning the requirement that the amount claimed for tax purposes must be charged in the accounts, since many thought it to be an inappropriate method of computing income. Since the removal of the booking requirement in 1954, many large companies have reverted to the straight-line method. This influence of the tax method on business practice may not be too serious because of the imprecise nature of depreciation, but it seems evident that the influence has been significant, and that the measurement of business income has been affected.

Aside from the acceleration of allowances over those which might be considered appropriate in arriving at business income (which will be

considered in the next chapter) the most significant departure from generally accepted accounting principles is the permissive nature of the capital cost allowance system. Taxpayers are allowed to claim all or any portion of the maximum allowances available without losing the benefit of the unclaimed portion; these amounts may be amortized in future years. This procedure is inconsistent with the principle that depreciation is an expense which must be recognized in determining business income, and has the unfortunate effect of obscuring the meaning of other provisions in the tax legislation and of creating inequities and anomalies between taxpayers. The prime example is the ability of a taxpayer with substantial depreciation expense to refrain from claiming capital cost allowance in loss years, thereby making the five-year limit on carrying forward of losses somewhat meaningless. Although an examination of the loss carry-forward provisions is not within the scope of this study, it is interesting to note at this time that the limitation on the carry-forward of losses itself is contrary to the going-concern concept of business. Under this concept it is recognized that income can only be precisely determined on the termination of a business, and that annual measurements are merely interim calculations made to determine progress.

It would appear, therefore, that the permissive nature of the capital cost allowance system, although inconsistent with generally accepted accounting principles, helps to compensate for that other departure from accounting concepts embodied in the restrictions on the carry-forward of losses.

A solution to the inequities arising from the permissive nature of the system would, therefore, necessarily depend on the restrictions (if any) retained with respect to the carry-forward of losses.

Adequacy of Allowances. A good indication of the adequacy of maximum allowances permitted under our present system can be obtained by comparing the amount of the depreciation allowances recorded in taxpayers' accounts with the capital cost allowance claimed for tax purposes. As mentioned above, there is good evidence that the best measure of depreciation is obtained by the straight-line rather than the diminishing balance method and, accordingly, the deductions provided by the capital cost allowance system (at double the rates under a straight-line method) are higher in the early years and lower in later years than might be considered appropriate for business purposes.

In the confidential survey of corporations conducted by this Commission, the majority used a different method of depreciation in their accounts, and for the years 1955 to 1962 capital cost allowances claimed exceeded depreciation recorded in the accounts of these corporations by approximately \$1,200 million (Table 3-8).

The total deferment of tax resulting from these additional allowances is estimated to be approximately \$700 million at the end of 1962. These figures substantiate the opinion of many informed taxpayers that the allowances permitted under the present capital cost allowance system are, in the early years at least, in excess of what is required reasonably to measure true depreciation. The capital expenditures of all the corporations surveyed represented about 25% to 30% of total capital expenditures in Canada for the years 1955 to 1962 (Chart 3-10). If depreciation for the corporations surveyed is representative of all Canadian industry, it would appear that the accumulated tax deferment for all industry is in the order of \$1,000 to \$2,000 million to the end of 1962.

While the capital cost allowances are therefore generous in the short run, the more difficult question is whether they will be so in the long run. Based on theoretical analysis and statistics for the period 1955 to 1962, it is fairly evident that accumulated capital cost allowances will continue to exceed accumulated "true" depreciation, and that there will be a substantial element of permanent tax saving. While the rate of increase in the accumulated tax deferment is decreasing, there is little indication of a reversal (Chart 3-9). Even if there is some reversal, it will probably not be significant if the rate of capital expenditure of the last few years continues in the future.

Comparison of capital cost allowances in Canada with ordinary depreciation allowed in other countries is difficult because the classification of assets is different and in most countries rates are subject to negotiation. Table 1-1, which gives a brief comparison with rates in the United States and United Kingdom, indicates that the Canadian rates are slightly more generous.

Evaluation of Alternatives. The basic approach of the present system is to specify one particular method of amortization and the maximum rates applicable thereto. The principal alternative would be to allow the taxpayer to use any reasonable method of depreciation and to regulate, in some manner, the rates of depreciation allowed under the method chosen.

This latter more flexible approach was tried in Canada from 1917 to 1949 and was rejected. It is, however, followed in a number of other countries, including the United States.

The pre-1949 approach to tax depreciation, combined with recapture and terminal loss provisions such as recently adopted in the United States,

TABLE 1-1
COMPARISON OF NORMAL DEPRECIATION RATES*

	Canada	United States		United Kingdom
	Dim. Bal.	Dim. Bal.	St.-Line	
Electrical Generating Equipment - (taxpayer in business of supply-electrical energy) - Class 2				
Hydraulic	6%	4%	2%)	
Nuclear	6%	10%	5%)	
Steam	6%	7-1/7%	3-4/7%)	
Buildings of Solid Construction (including component parts) - Class 3				
Industrial buildings	5%	4-4/9%	2-2/9%	2% St.-Line
Apartments, hotels, theatres	5%	5%	2-1/2%	
Dwellings, factories, garages, machine shops, office buildings	5%	4-4/9%	2-2/9%	
Banks, stores	5%	4%	2%	
Grain elevators, warehouses	5%	3-1/3%	1-2/3%	
Chemical Pulp Mill (including paper finishing) Class 5**				
Pulp and paper (not finishing)	10%	12-1/2%	6-1/4%	
Paper finishing	10%	16-2/3%	8-1/3%	
Building of Frame, Log, Stucco or Galvanized Iron - Class 6	10%	No Comparable Distinction		
Ships - Class 7	15%	10%	5%	
Machinery and Equipment (includes all tangible assets not included in another class) - Class 8	20%	16-2/3%***	8-1/3%***	20% R.B.) 10% S.L.) usually
Radio Transmission, Receiving Equipment - Class 9	25%	33-1/3%	16-2/3%	
Automotive Equipment - Class 10				
Automobiles, including taxis	30%	66-2/3%	33-1/3%	
Buses	30%	22-2/9%	11-1/9%	
General purpose trucks -				
- 13,000 lbs.	30%	50%	25%	
+ 13,000 lbs.	30%	33-1/3%	16-2/3%	
Mining Machinery and Equipment (U.S. includes milling and primary preparation excluding smelting and refining) - Class 10	30%	20%	10%	
Patents - Class 14	Period of Protection			Shorter of 17 years or Period of Protection

* The above comparisons are not conclusive inasmuch as the rates in the United States and United Kingdom are guidelines (with the exception of the 2% straight-line rate for industrial buildings in the United Kingdom), and are subject to negotiation. Little information is available on the rates in other countries because they are mostly negotiated and, therefore, confidential. The above rates for the United States were extracted from guidelines published by the Internal Revenue Service. These rates vary by industry and comparison is therefore difficult. It is understood that guideline rates for the United Kingdom are set by industrial associations but these were not available at the time this report was prepared.

** The class is inoperative for mills acquired after the 1962 taxation year.

*** The guideline rate which is compared to Class 8 machinery and equipment is for manufacturing equipment excluding electrical and metal-working machinery and transportation equipment.

would provide a more accurate measure of depreciation than our present system since it would allow consideration of special factors relating to each taxpayer. The basic disadvantages of this approach are the administrative complexities which result from a multitude of depreciation rates and methods and the uncertainty which results when such rates are negotiable and confidential to each taxpayer.

Conclusion. The present system assures eventual amortization of the loss in value of depreciable assets and does so in a manner which is easy to comply with and economical to administer. In order to assure simplicity, the system sacrifices accuracy in the measurement of depreciation, and provides generous rates. These shortcomings do not, however, offset the advantages, and it is recommended that the basic system remain unchanged.

Two modifications of the basic system do, however, appear to be in order. To alleviate the hardship which arises under the method of grouping assets when a taxpayer has recurring losses on disposal of assets in a class, we recommend the adoption of the proposal put forward by the Canadian Institute of Chartered Accountants for an immediate deduction of the amount by which the undepreciated capital cost of the class exceeds the capital cost of assets actually remaining in the class. In addition, subject to amendment of the loss carry-forward provisions, we recommend that the claiming of capital cost allowances be mandatory, not permissive.

Secondary Problems. In addition to the primary problems arising from the basic provisions of the capital cost allowance system, there are also some problems which might be considered of a secondary nature. Many of these would arise regardless of the basic system adopted and others are peculiar to our present system. Only the more important of these problems are mentioned here; others are discussed in Chapter 5.

Lease Options. The repeal of section 18 of the Income Tax Act, 1/ although eliminating the possibility of tax avoidance through its provisions, leaves a loophole in the Act whereby taxpayers may circumvent the provisions of the capital cost allowance system. By disguising business transactions as leases (in various forms) taxpayers may be able to claim the cost of depreciable property as a deduction over a shorter period than that provided by the Regulations and/or claim the cost of property not otherwise deductible.

Although the Department of National Revenue hopes to rely on the present provisions of sections 12(1)(b) and 12(2) of the Act to control such tax avoidance schemes, they will have to be very aggressive to catch even the more obvious cases. In addition, it is not entirely certain that they will be successful in these cases without the help of the courts in looking beyond the form of the contracts to their substance. The Canadian courts have been somewhat reluctant to do this in the past.

In light of the foregoing, consideration should be given to adopting an approach comparable to that followed in the United States. Basically, this would mean elaborating on the present provisions of sections 12(1)(b) and 12(2) to encourage the tax authorities and the courts to look beyond the form of lease-option contracts to their substance in the light of the circumstances.

Proceeds of Depreciable and Non-Depreciable Property. Where land and buildings are transferred by sale between taxpayers and the buildings are subsequently demolished by the purchaser, it has been a practice of the Department of National Revenue to apply the provisions of section 20(6)(g) to ascertain the consideration received for the buildings by the vendor. This has resulted in a situation wherein taxpayers have been subject to

recapture of capital cost allowances on property having little or no economic value (evidenced by the fact that the property was destroyed by the purchaser), primarily because the section has been interpreted by the Department to mean that proceeds of disposition are to be determined by giving consideration to facts pertaining only to the vendor. An amendment designed to require consideration of all facts relative to any transaction of this nature is recommended. (See Chapter 5.)

REFERENCE

- 1/ Unless otherwise specifically provided, all statutory references are to the Income Tax Act, R.S.C. 1952, Chapter 148.

CHAPTER 2—HISTORY OF DEPRECIATION FOR
TAX PURPOSES IN CANADA

1917 TO 1949

The Income War Tax Act of 1917 provided for the deduction from income of "such reasonable allowances as may be allowed by the Minister for depreciation". 1/ In 1923, an amendment was added stating that a deduction should not be allowed in respect of "...any depreciation, depletion or obsolescence, except as otherwise provided by this Act". 2/

These provisions gave the Minister what appeared to be absolute discretion regarding depreciation and, as a result, informal rules were generally formulated over the years.

The most important of these rules were as follows:

1. Depreciation was allowed on the basis of wear and tear without consideration for obsolescence. Once an asset was sold or scrapped, no further deduction could be taken for obsolescence or undepreciated cost. As a result, for over 25 years businesses paid income tax on a basis which found no support from accountants, economists or engineers. 3/

2. Although the method of depreciation generally used for both accounting and tax purposes was the so-called straight-line method (described in detail later), taxpayers "were allowed to base their returns on the method which they usually followed". 4/

3. Over the years depreciation rates were established which, although not published, were generally known by taxpayers. The general rates of depreciation were maximum rates and had to be strictly adhered to,

except on the contrary authority of the Minister. Where lower rates were claimed by a taxpayer in the returns, a higher rate would not be subsequently allowed.

4. No provision was made for any increased allowance when plant and equipment were used at more than a normal rate 5/ until 1940 when extra depreciation, along with a degree of recapture, was introduced because of the war.

5. In a year of loss the taxpayer must charge at least half of the usual depreciation allowance. This, of course, did away with any coherence in the theory of depreciation, but at the same time was a benefit to taxpayers because it allowed them to postpone charging the depreciation allowance until a later year when profits were being earned. It was not, as might be thought, a punishment imposed for not making profits, and it may also be that the policy found favour with the government because it served to reduce the amount of losses which might be carried backward or forward against profits in other years. 6/

6. As pointed out above, accelerated depreciation, along with a degree of recapture, was introduced in 1940. After the war, double depreciation was introduced to stimulate the economy. These would appear to be among the first attempts by the Canadian government to use depreciation as an economic incentive.

7. For 14 years, beginning in 1940 when the Income War Tax Act was still in force, corporations and individuals carrying on business could not claim a deduction from income for depreciation unless the amount was set up on their books of account. The practice of allowing taxpayers to use the method of depreciation for tax purposes which they normally used on their books resulted, generally, in a set of rules which followed very

closely the established principles of good accounting practice to the extent that most taxpayers and accountants simply set up their records to conform to these rules.

As indicated at the outset, the Act apparently gave the Minister absolute discretion regarding depreciation, and was strongly criticized on the grounds that one taxpayer was not sure that he was getting as favourable treatment as the next because rulings were secret. The discretionary powers of the Minister were re-enforced by an amendment in 1940 which stated that "In computing the amounts of the profits or gains to be assessed, a deduction shall not be allowed in respect of 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". 7/ This gave the Minister the widest possible power to give or withhold a depreciation allowance, a power which resulted in no depreciation at all in some circumstances and double the rates allowed in others (i.e., in respect of plant and equipment representing a new investment). The former right to depreciation was reduced to nothing more than a bounty which the Minister could withdraw at will.

The 1940 amendment was prompted by the court decision in the Pioneer Laundry and Dry Cleaners case 8/ in which fully depreciated property was transferred between corporations owned by the same shareholders. The purchaser attempted to claim depreciation on his purchase price which was based on an appraisal by an independent appraiser. The Commissioner of Income Tax allowed no depreciation on the property on the grounds that there had been no change of ownership and that, therefore, the assets

were entitled to no further allowance (having already been fully depreciated). The Judicial Committee of the Privy Council ruled that the taxpayer not only had a statutory right to an allowance in respect of depreciation, but also that it should be a reasonable one. This decision upset the hitherto accepted interpretations of the statute.

Despite the Privy Council's ruling about a reasonable allowance, the Commissioner subsequently attempted to allow only a nominal allowance of \$1 a year. The Exchequer Court, however, upheld the taxpayer's claim for a higher allowance. 9/

In summary, at the time the capital cost allowance system was introduced in 1949, the Minister had full discretionary powers over deductions allowed for depreciation; depreciation was generally on a straight-line basis at official (but unpublished) maximum rates; there was no provision for recapture (except for limited recapture of accelerated or double depreciation) or terminal loss and, therefore, no recognition of obsolescence; and depreciation allowed was limited to the amount of depreciation recorded in the books of account.

1949 TO THE PRESENT

Basic Principles

The present capital cost allowance system was introduced as part of the new Income Tax Act of 1948 which was effective for 1949 and subsequent taxation years. When introducing the new Act to Parliament and explaining the changes from former legislation and practice, the Finance Minister made the following comments relating to depreciation allowances:

The House may recall that the income tax legislation of last year provided for an advisory board to review cases where ministerial discretion had been exercised under 43 designated provisions of the law. The House may be interested to know that of these 43 ministerial discretions only 2 remain in the new bill. 10/

One of the ministerial discretions dropped was that relating to depreciation allowances.

In the past, allowances have been granted on the basis of wear and tear of assets used in earning the income subject to tax. Under the new regulations...the governing principle will be the amortization of costs of depreciable assets. Incidentally, an effect of this will be to allow for obsolescence hitherto unrecognized under our Act. In the second place the rates of write-off will apply to the written down value of the asset account rather than to the total asset account. In the technical language of the accountant this means changing from the straight-line method of depreciation to the diminishing balance principle. Of course the rates of depreciation will be appropriately increased having regard to the diminishing balance principle. Thirdly, it is proposed to introduce what might loosely be described as a recapture provision. The provision will operate to ensure in effect that the deductions for amortizing the costs of an asset shall not exceed the final proven costs of the asset to the taxpayer. It will call for an adjustment against future write-offs where assets are disposed of after some use.

I believe that these principles...will be a further step towards greater simplicity in our system of taxing business profits.... The system will likewise be more equitable to the taxpayer and to the Treasury. 11/

From Mr. Abbott's remarks it would appear that the new system was meant to give the taxpayer a statutory right to depreciation allowances, to recognize the principle of amortization of costs against income, and to allow for obsolescence, while ensuring that allowances for depreciation for tax purposes would not exceed the proven cost of the asset to the taxpayer. The system was meant to be administratively simple and equitable.

The main features of the new capital cost allowance system designed to fulfil these aims are outlined below.

Statutory Right to Allowance For Capital Cost

Although section 12(1)(b) of the new Income Tax Act provides for a general prohibition against deductions in respect of capital expenditures, specific relief from its general provisions is provided in other sections of the Act. Thus, section 11(1)(a) allows depreciation to taxpayers as a statutory right instead of at the discretion of the Minister, as was formerly the practice. In presenting the bill to the Senate, Senator Hugesson had this to say on the matter:

We heard a good deal in the special committee on the question of allowance for depreciation. Honourable Senators will remember that the present Act puts it in negative form. Subsection 1(n) of Section 6 of the Act provides that no deductions from income shall be allowed for depreciation...except such amounts as the Minister in his discretion may allow. Two objections to that provision were raised before the special committee. The first was that it was stated in a negative way, when in fact depreciation is well recognized the world over, and the taxpayer should have a positive right to a reasonable allowance for it. The second objection was that the section left discretion to the Minister, who, theoretically, might favour one taxpayer at the expense of another, and it was contended that in any event there were no published rules or regulations showing just what amounts of depreciation should be allowable for any particular class of goods or articles. That point is dealt with in the new bill under Section 11, subsection 1(a) by which it is provided in positive terms that the taxpayer may deduct...such part of the capital cost to the taxpayer of property, or such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation. 12/

In the same Debates, Senator Hayden presented an opposing view:

...discretion is a good thing to have because it gives a flexibility to the Statute that it would otherwise not possess. Discretion, which is the ability of a taxing officer to make a

recommendation in a special case, is a good thing so long as the exercise of that discretion is circumscribed in some way by the right to have a check made upon it. 13/

However, the critics of the policy of ministerial discretion had become increasingly vocal (particularly since the Pioneer Laundry incident and the ensuing amendment) with the result that the government felt obliged to constitute an advisory board to review cases where ministerial discretion was exercised. Before this board became effective the new Act was introduced which abolished ministerial discretion in all but a few instances.

Reducing Balance

The government chose to amortize the costs of depreciable assets for tax purposes in all but a few cases 14/ through a mandatory diminishing or reducing balance method (described in Chapter 4) whereby the rates of depreciation are applied to the undepreciated capital cost. Undepreciated capital cost is defined roughly as original cost minus (1) all amounts previously allowed for depreciation (before 1949), (2) capital cost allowance in respect of the amounts included in the class, and (3) the proceeds from the disposal of assets not in excess of original cost which were previously included in the class.

An exemption from the mandatory diminishing balance method was granted to farmers and fishermen who were given the option of remaining on the straight-line basis of depreciation or of switching to the new method. Once an election to use the diminishing balance method was made, however, the farmer could not return to the straight-line method. Farmers and fishermen who continued on a straight-line basis were also excluded from recapture and terminal loss. According to Mr. Abbott:

Any small farmer who might find it difficult to keep records in such a way that he can operate on this principle, which apparently requires the keeping of slightly more detailed records, can continue on the straight-line basis. That was the reason for making the exemption for farmers and fishermen. 15/

In the view of Mr. Abbott, the use of the reducing balance method would result in a deduction for tax purposes in accordance with good accounting treatment of depreciation. In the House of Commons debate on the subject he stated that:

...whether it is straight-line depreciation or whether it is on the diminishing balance principle, what you are doing is amortizing capital cost. That is the fundamental principle of depreciation.... There is no difference in the principle of taking depreciation under either system. It is a process of amortization of a capital expenditure, a recognition of the principle that you should not pay tax on something which is going to disappear. That underlies the whole basis of depreciation. 16/

Regulation 1100(4)

Regulation 1100(4), so long as it was in effect, tended to force the adoption of the reducing balance method for financial accounting purposes by providing that taxpayers could not claim a deduction from income in respect of capital cost which was in excess of the amount recorded on the books of account. The government withdrew this Regulation in 1954 and since then taxpayers have been able to claim capital cost allowance in one amount for tax purposes, and deduct depreciation in another amount on their books of account. The tendency in many instances for book depreciation to vary considerably from capital cost allowances claimed for tax purposes is a feature of the present system which will be examined in detail later.

Increased Depreciation Rates

With the adoption of a reducing balance method of depreciation for

tax purposes it was necessary to change the rates of depreciation accordingly. The rates of capital cost allowance were established, for most items, at double the rates formerly allowed on the straight-line basis. Thus, the taxpayer received greater allowances than formerly for a number of years following the acquisition of an asset, and smaller allowances in those later years in which the written-down balance was less than half of the original cost. These rates were made official, given the force of law, and published for the benefit of all taxpayers.

Allowance Claimed at Taxpayer's Discretion

Under the new Act taxpayers were given the option of claiming any amount of capital cost allowance in a given taxation year from nil up to the maximum rates provided by the Income Tax Regulations. If maximum allowances were not claimed in a year, the right to them was not lost, since the balance of cost on which allowances are calculated was not reduced. This contrasted with the pre-1949 system which required at least one half of the depreciation allowance to be claimed in a taxation year.

The permissiveness in the capital cost allowance system is contradictory to the general principle that depreciation is an expense incurred in the process of earning income. To the extent that capital cost allowances represent a measure of the depreciation of property, there is little logic in allowing the taxpayer to claim the allowance at his discretion.

Recognition of Obsolescence

One effect in the switch in the tax treatment of depreciation to amortization of capital cost was to allow for obsolescence which previously had not been recognized. Although it is necessary for the taxpayer to have

acquired the property for the purposes of gaining or producing income (Regulation 1102(1)(c)) before he may claim capital cost allowances, they may be claimed whether the assets continue to be used to earn income or whether they remain the legal property of the taxpayer, provided the property is not converted to his personal use. The system guarantees the recovery of the cost of capital assets from profits and, in effect, grants an allowance for obsolescence on discarded machinery and plant by allowing its original cost to be recovered, even though the asset has ceased to be used in the income-earning process. The entire amount of undepreciated capital cost is not immediately deductible unless disposition is made of all assets in the class. (See "Classes of Assets", below.)

The reducing balance method and the generous rates of allowance are also measures which, to a degree, help to recognize the importance of obsolescence in our present economy. By permitting larger allowances in the early years of the useful life of an asset, the system reduces the likelihood that sudden obsolescence will result in substantial losses which will be deductible only gradually over a period of years.

Recapture

The recapture provision is the opposite to the terminal loss provision outlined briefly above. It is designed to assure that the allowances for capital cost do not, in total, exceed the final proven cost of the asset to the taxpayer. Mr. Harvey Perry has described the operation of the recapture provision as follows:

...when a taxpayer realizes a value from the sale or other disposition of a capital asset, the amount so realized must be offset against the capital cost allowance which he may claim in the future against assets of that class. The effect therefore is

that the value the taxpayer has recovered by the sale may not again be recovered through a deduction from income. This offset against future depreciation is restricted to a maximum amount equal to the original capital cost of the asset; in short, no account is taken of a 'capital gain' derived from the sale of an asset at a price in excess of its original capital cost. Where the amount so recovered by a sale exceeds the value yet to be depreciated of assets of that class ('undepreciated value') the excess may in most cases be spread back over the preceding five years. 17/

Farmers and fishermen who do not elect to use the reducing balance method are not subject to recapture (section 20(8)), unless they have claimed a deduction under the Canadian Vessel Construction Assistance Act, in which case the allowances taken are subject to recapture (section 20(9)).

To prevent retroactivity of the recapture provisions applying to depreciation claimed prior to the 1949 taxation year, section 144 provides that, generally speaking, depreciable property acquired before the 1949 taxation year is deemed to have been acquired in the 1949 taxation year at actual capital cost less accumulated normal depreciation which has, or should have been taken. The actual cost is not reduced by any "extra" or "special" depreciation allowed, and is reduced by only one half of any double depreciation allowed. Certain additional adjustments are also required to be made.

Classes of Assets

The new system provides for depreciable assets to be grouped according to prescribed classes with a separate rate of depreciation assigned for each class. At the time of writing 18/ the Regulations prescribe 15 classes for all tangible assets which are amortized on a reducing balance method, two classes for certain intangible assets which are amortized on a straight-line basis and one class for which amortization is on a production basis.

Five other classes provide for accelerated allowances as economic incentives. In addition, a special rate is set for property of a class established by the Coal Production Assistance Act under section 1100(i)(h) of the Income Tax Regulations. The assets in each class have reasonably equal estimated life expectancies although varying widely in type. 19/

The grouping of assets into classes has a significant effect on the tax treatment of profits and losses arising on the disposition of depreciable property. As stated above, the capital cost allowance system provides an allowance for obsolescence by assuring the recovery of the cost of capital assets. This allowance for obsolescence may only be claimed at the same rate at which capital cost allowances would be allowed if the asset was still in use and living out its original estimated useful life unless disposition is made of all the property of the class of assets to which it belonged. If all of the assets of a particular class are disposed of for less than their undepreciated capital cost, the remaining cost which has not been claimed for tax purposes, less the proceeds of disposal (not exceeding original cost), may be claimed as a deduction from taxable income in the year of disposal (provided the taxpayer acquires no other assets of the class before the end of the taxation year). This is what has commonly become known as the "terminal loss" provision.

In addition to deferring the claim for losses on disposal, the group method also defers the recapture of allowances by allowing proceeds to be deducted from the cost of other assets in the class until such time as the proceeds exceed the total undepreciated capital cost of the class (of all assets, whether disposed of or not).

The theory behind this treatment of profits and losses is, of course,

that the profits on dispositions from a class would approximately equal the losses on such dispositions and that, therefore, the undepreciated capital cost remaining in the class will represent only those assets remaining in the class.

The system is concerned basically with amounts rather than things, the latter being important because they provide an amount of capital cost, but from then on the thing is lost sight of until it is sold or disposed of, when once again it provides an amount, this time a value on disposition. 20/ In the words of J. H. Perry, "No longer are pieces of machinery being depreciated; rather the capital cost of assets of approximately the same life is being recovered in computing the profits of the business". 21/ The establishment of classes of assets simplifies the amortization procedure for tax purposes and facilitates the process of adjustment for proceeds of disposal. 22/

Property Owned for Less Than Taxation Year

Under the capital cost allowance system, with the exception of property of farmers and fishermen depreciated on a straight-line basis, a full year's allowance may be claimed in the year of acquisition (regardless of when acquired) and no allowance is taken in the year of disposal (except for losses on disposal as explained above). This is largely a practical matter and is generally an acceptable accounting method of calculating depreciation allowances.

The main features of the capital cost allowance system, as it was introduced in 1949, remain unchanged today except for the repeal of the regulation requiring that capital cost allowances claimed for tax purposes be booked as depreciation by the taxpayer.

Related or Ancillary Provisions

The related or ancillary provisions of the Income Tax Act and the Income Tax Regulations which are primarily concerned with special circumstances are grouped into eight main categories for purposes of this study.

Rules Governing the Determination of Capital Cost

Non-Arm's Length Transactions. The capital cost of property acquired by a taxpayer through one or more transactions between persons not dealing at arm's length is deemed to be the amount that was the capital cost of the property to the original owner (section 20(4)). For this purpose, persons not dealing at arm's length are related persons as defined in section 139(5a), (5b), (5c), (5d) and (6) of the Act (i.e., individuals connected by blood relationship, marriage or adoption, and corporations subject to common control in specified ways).

When the actual price paid by the taxpayer is less than the capital cost to the original owner, the difference is treated as capital cost allowance allowed to the taxpayer and he is only permitted to claim capital cost allowances on the actual price paid by him.

In the absence of ministerial discretion which was in the Income War Tax Act, the rules governing non-arm's length transactions are necessary to prevent related taxpayers from artificially inflating their capital costs by transferring depreciable property among themselves. If allowed to do so, such taxpayers could claim allowances which, in total, would be substantially in excess of the cost of the property to the group. This is exactly what happened in the Pioneer Laundry case described earlier.

Property Converted from Personal to Business Use. The capital cost of property converted from personal use to business use is deemed to be the fair market value of the property at the time of conversion (section 20(6)(b)).

Property Acquired by Gift or Inheritance. The capital cost of property acquired by gift, bequest, or inheritance is deemed to be the fair market value of the property at the time of acquisition (section 20(6)(c)).

Property Partially Used for Business. Where property is partially used for business purposes and partially used for personal purposes the capital cost of the property is that proportion of the total cost that is equal to the proportion of the property that the use regularly made of the property for gaining or producing income is of the whole use regularly made of the property (section 20(6)(e)). The same rule applies to farmers and fishermen claiming under Part XVII (Regulation 1703(3)).

Change in Relationship Between Personal and Business Use. Where the relationship between personal use and business use of a property changes and,

- (i) business use increases, depreciable property is deemed to have been acquired at a capital cost equal to the present proportion of property used to earn income minus the former proportion of property used to earn income times the fair market value of the entire property at the time of change; or
- (ii) business use decreases, the taxpayer will be deemed to have disposed of depreciable property at an amount equal to the former proportion of property used to earn income minus the present proportion of the property used to earn income times

the fair market value of the property at the time of change (section 20(6)(f)).

Grants and Subsidies. The capital cost of property is reduced by the amount of any grant, subsidy or other assistance from a government municipality or other public authority received by the taxpayer to help him acquire or build the property (section 20(6)(h)), except for certain provincial grants received by certain co-operatives (section 73(3)(b)). The same rule applies to farmers and fishermen claiming under Part XVII (Regulation 1703(4)).

Bankrupt Corporations. Prior to the 1964 taxation year, where depreciable property of a corporation had, on a receiving order or on an assignment, become vested in a trustee in bankruptcy, the property was deemed to have been acquired by the trustee at a capital cost equal to the undepreciated capital cost of the asset to the corporation immediately before the time of vesting. This provision, that is, section 20(11) was repealed in 1963, applicable to the 1964 and subsequent taxation years. Section 65A, applicable to the 1964 and subsequent taxation years, provides that the income tax position of the bankrupt remains in general as it would be if the bankruptcy were disregarded (sections 65A(1)(c), 65A(2)(c)), the trustee in bankruptcy being deemed to be the agent of the bankrupt (sections 65A(1)(a), 65A(2)(a)).

Railway Companies. Railway track, railway track gradings and crossings are deemed for depreciation purposes to have been acquired at a capital cost equal to their value on the books of the taxpayer on December 31, 1955 (section 84A(1)).

Sale of Depreciable Farm and Other Property. Where a taxpayer has, during a taxation year, sold to one of his children either a farm or a farm together with other property used in farming operations, or a fishing vessel or a fishing vessel together with other property used in fishing operations, and his chief source of income during either that taxation year or the twelve months preceding it has been farming or fishing, the capital cost of the property to the child is the lesser of;

- (i) the fair market value of the property at the time of sale, or
- (ii) the capital cost to the child as determined under section 20(6)(g), (section 85H, Regulation 1703(6)). This is an exception to the general rule established under section 20(4) to the effect that where depreciable property is transferred in one or more non-arm's length transactions, the capital cost of the property to the transferee is deemed to be not greater than the capital cost to the original owner.

Amalgamations. Where two or more corporations have amalgamated, the undepreciated capital cost of property of a prescribed class immediately after an amalgamation will be the aggregate undepreciated capital cost of property of that class of all the predecessor corporations immediately before the amalgamation (section 85I(2)(d)).

Leasehold Interests. The capital cost of a leasehold interest acquired before 1949 is the depreciated value at that date for tax purposes plus all depreciation allowed thereon under the Income War Tax Act (Regulation 1102(6)).

Farming and Fishing Property Transferred at Non-Arm's Length. Where property belonging to a farmer or fisherman (who has claimed depreciation

under Part XVII of the Regulations) is transferred between persons not dealing at arm's length, the capital cost of the property to the taxpayer is the lesser of the actual capital cost of the property to the taxpayer or the amount by which the capital cost of the original owner exceeds depreciation taken or which should have been taken either under the Income War Tax Act or the Income Tax Act by the original owner and all intervening owners. This does not apply in the case of a sale between father and child in which case item (i) above applies (Regulation 1703(5)), nor in the case of property acquired by gift (Regulation 1703(7)).

Patents. Where all or part of the cost of a patent is determined by reference to the use of the patent the Regulations provide a formula for computing the capital cost thereof (Regulation 1100(9)).

Rules Governing the Determination of Proceeds on Disposal

Uncollectible Portion of Proceeds. A taxpayer may deduct any portion of the proceeds of disposition of depreciable property which becomes a bad debt (section 11(3d)).

Insurance Proceeds. Where depreciable property is destroyed or lost, and the proceeds of any insurance on such property exceeds the undepreciated capital cost of property of the class, the excess which would normally be included in income will be deemed not to be the proceeds of disposition in the year it is received or receivable, but will be proceeds of disposition in the following year to the extent that the taxpayer has in that year expended the insurance proceeds on replacing the property lost or destroyed. Where a building of one class, such as a frame building, is destroyed, and is replaced by a building of the same class or of another

class (i.e., a brick building), the insurance proceeds which are expended in the year following the loss or destruction on the acquisition or construction of the new building will be deemed to be proceeds of disposition of property of the class in which the new building falls, rather than proceeds of disposition of the building which was destroyed. Accordingly, the proceeds will not be subject to recapture under section 20(1) but will reduce the undepreciated capital cost of property of the class in which the new building falls. It will be observed, however, that this relief cannot be obtained if a building which is destroyed is replaced in the year of destruction by a building which is in a different prescribed class 23/ (section 20(5a)).

Property Converted from Business to Personal Use. Where business property is converted to personal use by the taxpayer, he is deemed to have disposed of that asset for purposes of the capital cost allowance regulations, and the proceeds of disposition are deemed to be the fair market value at the time of disposal (section 20(6)(a)).

Gifted Property. The proceeds of disposition of depreciable property given away, other than by will, is the fair market value at the time of the gift (section 20(6)(d)).

Proceeds of Depreciable and Non-Depreciable Property. Where an amount can reasonably be regarded as being partly in consideration for depreciable property and partly in consideration for something else, the portion of the amount in question that can reasonably be regarded as being the consideration for the disposition of depreciable property will be deemed to be the proceeds of disposition thereof in the hands of the vendor, and will be deemed to be the capital cost thereof to the purchaser, irrespective

of the form or legal effect of the contract or agreement in question, and regardless of the allocation of the purchase price made by the parties themselves (section 20(6)(g)).

Loss on Sale of Agreement for Sale or Mortgage. The proceeds of disposition of depreciable property in a taxation year shall be reduced by the amount of any loss sustained by a taxpayer on a sale in the same year of an agreement for sale or a mortgage or hypothec included in the proceeds of disposition, provided that both the disposal of the depreciable property and the sale of the agreement, mortgage or hypothec have been carried out at arm's length (section 20(6)(i)).

Bankrupt Corporations. Prior to the 1964 taxation year, where depreciable property of a corporation had, on a receiving order or assignment, become vested in a trustee in bankruptcy, the property was deemed to have been disposed of for an amount equal to the undepreciated capital cost to the corporation immediately before the time of vesting.

Where an amount, which included the proceeds of the sale of depreciable property in excess of the undepreciated capital cost of such property was repaid by the trustee to the corporation, after payment in full of all debts of the corporation and other costs, there was to be included in computing the income of the corporation for the taxation year in which the amount was received the lesser of the amount received, or the amount that would have been included in the income of the corporation if the property had been disposed of by the corporation immediately prior to the bankruptcy for the amount received in respect of the depreciable property by the trustee. This provision was repealed in 1963 applicable to the 1964 and subsequent taxation years (see page 32).

Election to Average Recaptured Capital Cost Allowances. A taxpayer who is required to include recaptured capital cost allowances in his income for a taxation year may elect to pay a tax on such recapture calculated on the basis of the additional tax which would have been paid if the amount recaptured had been added proportionately to certain immediately preceding years. The number of preceding years will be five unless the taxpayer was carrying on business (a corporation) or resident (an individual) in Canada for four years or less, in which case it will be the number of years the taxpayer was in business or resident in Canada (section 43).

1964 Amendment. A 1964 amendment provides for recapture when a partner disposes of his interest in a partnership and a part of the consideration may be deemed to have been received by him as proceeds of depreciable property (section 20(6)(j)).

Rules Governing the Determination of Allowances

Taxation Year Less than Twelve Months. Where a taxation year is less than twelve months in duration the amount of capital cost allowed as a deduction shall not exceed the proportion of the maximum amount allowable that the number of days in the taxation year is of 365. This limitation does not apply to the amortization of leasehold interests, patents, franchises, etc., timber limits, rights to cut timber, depreciable property used on timber limits, industrial mineral mines with bedded deposits (except gold mines), and terminal losses (Regulation 1100(3)).

Leasehold Interests. Briefly, expenditures on a leasehold interest are amortized on a straight-line basis by pro-rating the capital cost of the interest over the term of the lease, subject to a minimum of five years

and a maximum of forty years. If there is a right to renew the lease the term must include the next succeeding term (Regulation 1100(1)(b), Schedule H). The same rule applies to farmers and fishermen under Part XVII (Regulation 1700(5)).

Tramcars. Where a taxpayer ceases to operate tramcars, he may deduct 100% of the undepreciated capital cost to him of tramway track (Regulation 1100(5)).

Farm or Fishing Property Owned for Less than Taxation Year. Where a farmer or fisherman acquires or disposes of property during the taxation year on which he is claiming straight-line depreciation, the amount allowed as a deduction for depreciation shall not exceed that proportion of the maximum amount allowable that the number of months during which the property was used is of twelve (Regulation 1700(1)-(4)).

Total Allowances on Farm and Fishing Property Not to Exceed Capital Cost. The amount of depreciation allowed as a deduction to a farmer or fisherman who is on the straight-line basis shall not exceed the amount by which the capital cost of the property to the taxpayer exceeds the aggregate of the deductions from income allowed for previous taxation years (Regulation 1701).

Railway Sidings. Where a taxpayer has incurred an expenditure pursuant to a contract or arrangement with an operator of a railway system for the construction of a railway siding to his property or place of business, and under which the railway siding does not become the taxpayer's property, the taxpayer is allowed a deduction of 4% of the capital expenditure so incurred (Regulation 1100(8)).

Rules Governing the Classification
of Assets

Transfer of Assets Between Classes. Where depreciable property is transferred from one prescribed class to another, the undepreciated capital cost of the former class is adjusted so that it becomes the amount it would have been if the transferred property had never been in that class; the undepreciated capital cost of the property of the class to which the transfer is made is also adjusted by adding to it the capital cost of the transferred property and deducting the capital cost allowances that had been allowed in respect of the property while it was included in the former class (section 20(5b)).

Misclassified Property. Where property is classified incorrectly the Minister may direct that the property shall be deemed to have been properly included as property of the correct class prior to the commencement of the particular taxation year, and to have been transferred to the other class at the commencement of that year (section 20(5c)).

Separate Classes. Regardless of the classification of assets provided for in schedule B of the Regulations, properties acquired for the purpose of producing income from two or more businesses or partly from business and partly from property are split into separate classes (Regulation 1101(1)). In addition, timber limits, industrial mineral mines (as described in Regulation 1100(1)(g)), certain fishing vessels, and property deemed to have been acquired by the taxpayer by former section 18 of the Act are deemed to be separate classes of assets (Regulation 1101 (2)-(5)).

It should be noted that Regulation 1101(1) has recently been held to be ultra vires by the Tax Appeal Board:

...inasmuch as it imposes taxation in certain circumstances wherein the specific provisions of the Income-Tax Act grant relief from taxation. In the Board's opinion, it is evident from the provision of Section 20(2) that, when all of the assets of a prescribed class are sold in one year, and new assets of the same class are subsequently obtained in that year, the new assets will be used in a different business from that previously carried on. Nevertheless, Section 20(2) provides for relief from taxation. Notwithstanding this specific relief afforded in the legislation, Section 1101(1) of the Regulations proceeds to overrule the specific provisions enacted by Parliament. The regulation was contrary to the law as contained in Section 20(2) of the Act. 24/

The Board's decision in this case is under appeal.

For the same reason, it would appear that under this decision, the other subsections of Regulation 1101 would be ultra vires as well.

Property Not Included. The classes of property described in the Regulations and in Schedule B thereto do not include deductible expenses, inventory, scientific research expenditures, property that was not acquired by the taxpayer for the purpose of gaining or producing income, property that is included in a class established by the Coal Production Assistance Act or the Canadian Vessel Construction Assistance Act, property on which a farmer or fisherman elects to claim straight-line depreciation, passenger vehicles acquired after June 13, 1963, costing over \$5,000, property deemed to have been acquired under lease-option but where title did not vest before the 1963 taxation year, land, and property owned by a non-resident and situated outside of Canada (Regulation 1102(1)-(3)). Taxpayers who are farmers and fishermen and who have elected to claim depreciation on a straight-line basis are not allowed to deduct depreciation in respect of deductible expenses, inventory, scientific research expenditures, property that is included in a class established by the Canadian Vessel Construction Assistance Act, property that was not used in the business during the year,

animals, trees, shrubs, herbs or similar growing things, property that was not acquired by the taxpayer for the purpose of gaining or producing income from farming or fishing, or that has been included at any time by the taxpayer in a class established under Part XI of the Regulations (i.e., capital cost allowance classes on which the reducing balance method is used), passenger vehicles acquired after June 13, 1963, costing over \$5,000, land, and property that is situated outside Canada (Regulation 1702(1)-(3)).

Buildings on Leased Property. Amounts expended by leaseholders on buildings or other structures, additions to buildings or other structures, or alterations to buildings which substantially change the nature or character of the leased property, are included in the same class as buildings and other structures owned by the taxpayer and situated on his own land (Regulation 1102(4), (5)).

River Improvements. Amounts expended by a taxpayer on river improvements for the purposes of facilitating the removal of timber from a timber limit are included in the same class as the cost of the timber limit (Regulation 1102(7)).

Electrical Plant Used for Mining. Equipment generating or distributing electrical energy, 80% of the output of which was sold to or used by a mine or a mine and a smelter or an ore mill, is included in Class 10 in Schedule B of the Regulations. The 80% output is to be computed on the basis of the output for the distributor's 1948 and 1949 taxation years, or his first two taxation years, whichever period is the later (Regulation 1102(8), (9)).

Railway Companies. Railway company property described in section 84A of the Act is included in Class 4 in Schedule B of the Regulations (Regulation 1102(10)).

Inclusion of Other Properties in Classes 1, 2, 4 and 17. All properties acquired for the purpose of gaining or producing income from the same business which would otherwise be included in Classes 2 to 12 of Schedule B of the Regulations may be included in Class 1 of Schedule B, at the election of the taxpayer (Regulation 1103(1)). Where a taxpayer's chief depreciable properties are included in Class 2, 4 or 17 of Schedule B, the taxpayer may elect to include all such assets in one of these classes. To be effective in respect of the taxation year, an election must be made not later than the last day on which the taxpayer may file a return of his income for the taxation year (Regulation 1103(2), (3)).

The advantages of such an election would be the simplification of the computation of the taxpayer's capital cost allowance and, possibly, the advantage of deferring recapture of depreciation on the sale of some of the assets. However, it should be noted that in a recent decision the Tax Appeal Board 25/ largely removed the second advantage when they held that Regulation 1103 could not be construed to allow a taxpayer to make an election which would affect assets sold prior to such an election, for such a construction would bring it into conflict with the clear requirement of section 20(1) of the Act. The Regulations could not be allowed to override the Act: when the two are in conflict, the Regulations must give way.

Rules Governing Property Acquired Through
Option-Agreements, Hire-Purchase
Agreements and Other Similar
Arrangements (Repealed in 1963)

Where a taxpayer entered into a contract under which property (other than immovable farm property) was leased or hired and it was agreed that, upon the satisfaction of a condition, the property might vest in the taxpayer or any other person not dealing at arm's length, such agreements were

treated as agreements of sale with respect to the purchaser, and all payments thereunder were deemed to be payments on account of the purchase price, rather than rental for the use of the property. The property was deemed to be purchased by the lessee at a capital cost equal to the price fixed by the contract or agreement which was interpreted to be the sum of the rental payments plus the terminal payment on exercise of the purchase option. 26/

The section, in effect, restricted the deductions from income of the lessee, in respect of property which is the subject of such an agreement, to the equivalent of the capital cost allowances under section 11(1)(a) on the portion of the deemed purchase price attributable to depreciable property. The rental payments were not deductible.

Where the lessor and lessee were not dealing at arm's length, the capital cost of the property to the lessee was deemed to be the capital cost to the lessor. The section also made provision for recapture of capital cost allowance taken by the lessee in certain circumstances. The section was concerned with the income of the lessee and any other person who may acquire the property under the agreement, but had no effect on the lessor's income.

Certain lease-option and hire-purchase agreements entered into after 1957 were exempted from the effects of section 18 if the amounts fixed by the contract or arrangement as the price at which the property could be purchased were not less than a stipulated percentage of the fair market values of the property at the time the taxpayer entered into the contract. This permitted taxpayers entering into such agreements for bona fide business reasons to escape the restrictions of section 18.

Section 18 has been repealed for the 1963 and subsequent taxation years.

Economic Incentives

Allowances in Respect of Defence Production. Additional capital cost allowance may be claimed (in excess of the usual rates allowed) on assets for which certificates are granted by the Minister of Defence Production. As implied, the purpose of this was to promote the expansion of facilities essential to defence efforts (Regulation 1100(1)(j), (k), 1106).

Deferred Allowances. No capital cost allowance could be claimed for approximately two years on certain assets acquired after April 10, 1951 and prior to January 1, 1953. "The purpose of this order was to encourage taxpayers, where appropriate, to defer capital projects in order to assist in the carrying out of an expanding defence programme, to alleviate material shortages, ease a tight labour market and to reduce inflationary pressures on the national price level resulting from a record volume of investment", 27/ (Regulation 1107).

Additional Allowances in Respect of New Products. A more rapid write-off may be taken on certain assets purchased after December 31, 1960, and before 1963, principally for the purpose of producing a new product either in Canada or in a prescribed area in Canada. This Regulation was apparently an effort to provide a stimulus to promote the production of products new in Canada or new products in specified surplus manpower areas in Canada (Regulations 1100(1)(1), 1108).

Allowance for Re-Equipment and Modernization. An additional capital cost allowance may be taken in the year of acquisition in respect of certain

assets acquired in the period commencing June 21, 1961 and ending March 31, 1964. The additional allowance applies only to those capital expenditures which are in excess of normal or ordinary expenditures (i.e., base). "This re-equipment and modernization allowance is one of the 1961 Budget proposals to encourage and assist Canadian business to become more competitive in markets abroad and at home. It is intended to help business undertake new capital installations including machinery, equipment and buildings", 28/ (Regulations 1100(1)(m), 1109).

Scientific Research. Originally there was provision for a yearly write-off of one third of capital expenditures in respect of scientific research (provided the research programme was approved). At present, all such capital expenditures can be written off in the year of acquisition (from 1960 on). There is now no limitation on the amount of expenditures deductible under section 72 and all capital expenditures (with the exception of expenditures on land) may now be written off in the year of acquisition regardless of the nature and life of the asset. In addition, for the taxation years 1962 to 1966, section 72A provides that a taxpayer may deduct an additional 50% of his current and capital expenditures in Canada on scientific research which represents an increase over the expenditures incurred in the base year and after deducting certain payments received by the corporation in respect of scientific research undertaken by it. This additional allowance represents the only departure from the principle of amortization of historical costs. In all other instances the amortization has merely been speeded up, with all additional allowances being subject to recapture on disposal.

Although there is provision for recapturing some of the additional deductions on expenditures of a capital nature allowed, the recapture is

limited to 50% of the proceeds of disposition not in excess of original cost. Thus, where the proceeds are less than cost, or where the property is retained indefinitely by the taxpayer, the deductions allowed for the capital expenditure could be in excess of original cost.

Sections 85I(2)(jb) and (jc) spell out the rules regarding deduction of scientific research expenditures by amalgamated corporations.

The Budget address of April 26, 1965, indicated that new legislation would be introduced, applicable to the 1967 and subsequent years, to provide a grant or a credit against tax liability of 25% of a defined amount of expenditure on scientific research or development incurred by a business. For 1966 a business will be permitted to elect to avail itself of either the provisions of the Income Tax Act or of the proposed new legislation.

Accelerated Depreciation for Residents and Corporations with a Degree of Canadian Ownership. In his Budget speech of June 13, 1963, the Finance Minister indicated that new depreciable property of a prescribed class (Class 8—machinery and equipment) acquired in the period of 24 months, commencing June 14, 1963, may be depreciated on a straight-line basis at a rate not exceeding 50% per annum, if the property has been acquired by a taxpayer in a taxation year for a manufacturing or processing business in Canada, and the said taxpayer is (a) a taxpayer who was resident in Canada during a period of not less than 183 days in the year, or (b) a corporation that on the last day of the year was a corporation with a degree of Canadian ownership (Regulation 1100(1)(n), (o), Class 19). The Budget address of April 26, 1965, forecast that this measure would be extended to cover machinery and equipment acquired until December 31, 1966.

In addition, a taxpayer whose business in a prescribed area of Canada has been certified to be a new manufacturing or processing business that commenced operations beginning with the passing of enabling legislation, December 5, 1963, and before April 1, 1967, may claim capital cost allowances on new machinery acquired in that period, at a rate not exceeding 50% per annum on the straight-line basis, and on new buildings or extensions to buildings completed in that period at a rate not exceeding 20% per annum on a straight-line basis (Regulation 1100(1)(p), (q), Classes 20 and 21). The foregoing incentive supersedes and replaces Regulations 1108 and 1109 (previously described) and section 40A of the Act (repealed) which provided for a tax credit to certain companies based on increased sales.

Other Incentives. Certain fishing vessels are entitled to additional allowances (Regulation 1100(1)(i)).

Investment Allowances. Unlike the United Kingdom, the Canadian tax depreciation system does not, with the exception of scientific research expenditures, allow deductions for capital cost to exceed the historical cost of the property. The investment allowance in the United Kingdom is a form of tax subsidy, in that a portion of the cost of property is allowed as a deduction without reducing the capital cost of the property on which normal depreciation allowances are calculated. In effect, the taxpayer is allowed total deductions in excess of the cost of the asset to the taxpayer.

Investment allowances and similar arrangements have never been a part of the Canadian capital cost allowance system.

Employees' Automobiles

Certain employees, for example, salesmen, purchasing agents, etc., may be entitled to a deduction in respect of expenses laid out to earn

their income under the provisions of sections 11(6) or 11(9). If they are entitled to deductions under either or both of those sections then, under section 11(11), they are entitled to capital cost allowance on their automobiles. Regulation 1100(6) provides for a capital cost allowance in these circumstances of 30% on the diminishing balance system.

Trust or Estate Property

A beneficiary may claim a deduction from his income from the trust or estate in respect of an amount of capital cost allowance deductible in respect of the trust or estate property as the trust or estate may determine. Any amounts so deducted by a beneficiary may not be again deducted by the trust or estate from its income; however, for the purposes of the recapture provisions of section 20 the amount of capital cost allowance claimed by the beneficiary is deemed to have been deducted by the trust or estate (section 63(8)).

REFERENCES

- 1/ The Income War Tax Act, R.S.C. 1927, c. 97, s. 5(a).
- 2/ Ibid., s. 6(b).
- 3/ Stuart Thom, "Depreciation and Income Tax", The Canadian Banker, Winter 1951, p. 125.
- 4/ Ibid., p. 126.
- 5/ Ibid., p. 125.
- 6/ Ibid., p. 125.
- 7/ Income War Tax Act, R.S.C. 1927, c. 97, s. 6(1)(n).
- 8/ Pioneer Laundry and Dry Cleaners, Ltd. v. M.N.R., 1 DTC 499-69; [1938-39] C.T.C. 411.
- 9/ Pioneer Laundry and Dry Cleaners, Ltd. v. M.N.R., [1942] C.T.C. 201; 2 DTC 595.
- 10/ Finance Minister Abbott, House of Commons Debates, Hansard, 1948, p. 5505.
- 11/ Ibid., pp. 1799-1800.
- 12/ Senator Hugesson, Senate Debates, Hansard, June 24, 1948, p. 659.
- 13/ Senator S. A. Hayden, Senate Debates, Hansard, June 24, 1948, p. 661.
- 14/ As of March 1965, the Regulations prescribe 15 classes for tangible assets which are amortized on a reducing balance method, two classes for certain intangible assets which are amortized on a straight-line method and one class for property used in the forest industry which is amortized on a production basis. Five other classes provide for accelerated allowances as economic incentives. In addition, properties such as woods assets and industrial mineral mines are amortized on a production basis.
- 15/ Finance Minister Abbott, House of Commons Debates, Hansard, 1950, p. 2607.
- 16/ Ibid., p. 2611.
- 17/ J. Harvey Perry, Taxation in Canada, 3rd Edition, University of Toronto Press, Toronto, 1961, p. 69.
- 18/ March 1965.

- 19/ J. Harvey Perry, "Depreciation Practices in Foreign Countries", Depreciation and Taxes Symposium, Princeton, New Jersey; Tax Institute, 1959, p. 194.
- 20/ Stuart Thom, "Depreciation and Income Tax", The Canadian Banker, Winter 1951, p. 125.
- 21/ J. Harvey Perry, Taxation in Canada, 3rd Edition, University of Toronto Press.
- 22/ Ibid., p. 70.
- 23/ Canadian Tax Reporter, CCH Canadian Limited, para. 11-720.
- 24/ Edward S. Touzeau v. M.N.R., 63 DTC 1 (TAB); 30 Tax A.B.C. (1962-63), 301.
- 25/ G.H.C. Investments Ltd. v. M.N.R., 61 DTC 1120 (Ex. Ct.); [1961] C.T.C. 187.
- 26/ The Exchequer Court in L. J. Harris v. M.N.R., 64 DTC 5332; [1964] C.T.C. 562, found that this is not the proper method of calculating the deemed capital cost of a lease-option asset.
- 27/ Explanatory Memorandum of the Department of Trade and Commerce, Canadian Tax Reporter, Toronto: CCH Canadian Limited, para. 11-134.
- 28/ Explanatory Memorandum of the Minister of Finance, Canadian Tax Reporter, Toronto: CCH Canadian Limited, para. 11-134f.

CHAPTER 3—AN EVALUATION OF THE BASIC SYSTEM

ORIGINAL OBJECTIVES

Amortization of Cost

As we have seen, the governing principle of the capital cost allowance system is the amortization of costs of depreciable assets whereas the old system granted allowances for depreciation basically on the basis of wear and tear. By "amortization of costs" the government appears to mean that the total proven cost (and no more) of an asset to a taxpayer can be deducted over a period of years in the computation of his income, thus allowing for such factors as obsolescence and excessive use. Non-taxable gains or non-deductible losses arising from the over- or under-depreciation of depreciable property under the previous system are eliminated under the new system.

The switch from wear and tear depreciation to full amortization of capital cost was facilitated by the introduction of two relatively new principles in Canadian tax depreciation.

Continuation of Allowance After Use Expired. Eventual amortization of cost under the capital cost allowance system is assured because allowances can be claimed on the cost of the property even though it is no longer used in the business of the taxpayer. This is accomplished by the application of a reducing balance method (for most property) of depreciation to the combined cost of groups of assets, including non-capital profits and losses realized on the disposal of assets previously in the group or class:

The grouping of assets is based on a theory of "average service life", that is, although some assets in a class may have a shorter useful life than the average for the class, others will have a longer life, and a rate based on the estimated average will be representative.

Although full amortization of cost is assured under this system, and the averaging principle is generally satisfactory from the point of view of the Department of National Revenue and the taxpayer because it introduces a much desired element of simplicity, it can also result in the following anomaly.

Retention of Profits and Losses. In order that the theory of "average service life" be valid, it is necessary to leave in the pool of cost any profits or losses realized on the disposal of assets of a particular class. This is the practice followed in our present capital cost allowance system. There is an important difference, however, between the practical application of this theory for accounting purposes and its use for tax purposes. In accounting for depreciation on a taxpayer's books in this way, if disposals or retirements in significant amounts take place for reasons not contemplated when the group depreciation rates were established, with the result that the presumption of "average service life" is invalidated, a profit or loss may be recognized on the books at the time it is incurred. The requirements of the tax law and the related regulations governing capital cost allowances do not permit this flexibility.

Because of this rigidity in the tax system, the retention of profits and losses in the pool of cost may be distorting when compared to the generally accepted accounting treatment of such profits and losses.

Tables 3-1 and 3-2 illustrate the distortion which arises when assets of a class are disposed of at substantial profits or losses.

Table 3-1 compares the computation when a building costing \$100,000 with an undepreciated capital cost of \$40,000 is sold for \$90,000, thus creating a possible \$50,000 recapture of capital cost allowance for tax purposes (the building is the only one of its class), and similar book profit in the taxpayer's account. A new building of the same class is then built or purchased in the same year at a cost of \$50,000. The result under the present system is that the new building, although being new and costing \$50,000 (which is the amount that would be depreciated on the books of the taxpayer), has no capital cost for tax purposes, because the \$50,000 recapture on the original building is used to reduce the capital cost of the new building. Table 3-2 illustrates a similar situation except that in this case the asset is sold at a \$30,000 loss and is replaced in the class by a new building costing \$5,000. The capital cost of the new building for tax purposes is now \$35,000, whereas it would be recorded on the books of the taxpayer at only \$5,000.

In both instances the distorting effect of the class system in extreme situations can be seen, and it will tend to become a more serious problem the longer the present system continues. At present, in most situations, there would appear to be little distortion.

Tables 3-3, 3-4 and 3-5 compare the computations if recapture and terminal allowances were allowed on an individual asset basis in our present system. Table 3-3 assumes that total profits on disposal are approximately equal to total losses; Table 3-4 assumes continued profits on disposal; Table 3-5 assumes the opposite: that is, continued losses on

TABLE 3-1

COMPARISON OF TAX AND ACCOUNTING TREATMENT
WHERE BUILDING IS SOLD FOR A PROFIT AND
REPLACED BY ANOTHER BUILDING OF THE
SAME CLASS IN THE SAME YEAR

	<u>Tax Method</u>	<u>Accounting Method</u>
Cost of building	\$100,000	100,000
Accumulated capital cost allowances (depreciation)	<u>60,000</u>	<u>60,000</u>
Undepreciated capital cost (net book value)	40,000	40,000
Proceeds on disposal	<u>90,000</u>	<u>90,000</u>
Amount subject to recapture (profit recorded on sale)	-50,000	<u><u>-50,000</u></u>
Addition at cost	<u>50,000</u>	<u>50,000</u>
Undepreciated capital cost at year end (net book value)	<u><u>\$ 0</u></u>	<u><u>50,000</u></u>

TABLE 3-2

COMPARISON OF TAX AND ACCOUNTING TREATMENT
WHERE BUILDING IS SOLD AT A LOSS AND
REPLACED BY ANOTHER BUILDING OF THE
SAME CLASS IN THE SAME YEAR

	<u>Tax Method</u>	<u>Accounting Method</u>
Cost of building	\$100,000	100,000
Accumulated capital cost allowances (depreciation)	<u>60,000</u>	<u>60,000</u>
Undepreciated capital cost (net book value)	40,000	40,000
Proceeds on disposal	<u>10,000</u>	<u>10,000</u>
Amount subject to terminal loss allowance (loss recorded on sale)	<u><u>\$ 30,000</u></u>	<u><u>30,000</u></u>
Addition at cost	<u>\$ 5,000</u>	<u>5,000</u>
Undepreciated capital cost at year end (net book value)	<u><u>\$ 35,000</u></u>	<u><u>5,000</u></u>

TABLE 3-3
COMPARISON OF TREATMENT OF PROFITS AND LOSSES ON DISPOSAL OF FIXED ASSETS ON A GROUP BASIS WITH THE TREATMENT ON AN INDIVIDUAL ASSET BASIS USING REDUCING BALANCE METHOD AND ASSUMING PROFITS APPROXIMATELY EQUAL TO LOSSES OVER THE LONG RUN

	Group Basis	Individual Asset Basis					Profit (Loss) on Disposal
		1	2	3	4	5	
Capital cost	\$500,000	100,000	100,000	100,000	100,000	100,000	500,000
Capital cost allowance - 1st year	100,000	20,000	20,000	20,000	20,000	20,000	100,000
Undepreciated capital cost	400,000	80,000	80,000	80,000	80,000	80,000	400,000
Beginning of 2nd year -							
Disposal of asset No. 1 at \$90,000	90,000	80,000	-	-	-	-	10,000
Capital cost allowance - 2nd year	310,000	-	80,000	80,000	80,000	80,000	320,000
Undepreciated capital cost	62,000	-	16,000	16,000	16,000	16,000	64,000
Beginning of 3rd year -	248,000		64,000	64,000	64,000	64,000	256,000
Disposal of asset No. 2 at \$50,000	50,000		64,000				(14,000)
Capital cost allowance - 3rd year	198,000		-	64,000	64,000	64,000	192,000
Undepreciated capital cost	39,600		-	12,800	12,800	12,800	38,400
Beginning of 4th year -	158,400			51,200	51,200	51,200	153,600
Disposal of asset No. 3 at \$50,000	50,000			51,200			(1,200)
Capital cost allowance - 4th year	108,400			-	51,200	51,200	102,400
Undepreciated capital cost	21,600			-	10,200	10,200	20,400
Beginning of 5th year -	86,800				41,000	41,000	82,000
Disposal of asset No. 4 at \$46,000	46,000				41,000		5,000
Capital cost allowance - 5th year	40,800				-	41,000	41,000
Undepreciated capital cost	8,200				-	8,200	8,200
Beginning of 6th year -	32,600					32,800	32,800
Disposal of asset No. 5 at \$32,600	32,600					32,800	(200)
Undepreciated capital cost	\$ -					-	-
Capital cost allowances minus profits or plus losses on disposal		Individual Asset Basis					
1	\$100,000	100,000					
2	62,000	54,000					
3	39,600	52,400					
4	21,600	21,600					
5	8,200	3,200					
6	-	200					
		<u>231,400</u>					

TABLE 3-4

COMPARISON OF TREATMENT OF PROFITS AND LOSSES ON DISPOSAL OF FIXED ASSETS ON A
GROUP BASIS WITH THE TREATMENT ON AN INDIVIDUAL ASSET BASIS USING
REDUCING BALANCE AND ASSUMING CONTINUED PROFITS ON DISPOSAL

	Group Basis	Individual Asset Basis					Profit (Loss) on Disposal
		1	2	3	4	5	
Capital cost	\$500,000	100,000	100,000	100,000	100,000	100,000	500,000
Capital cost allowance - 1st year	100,000	20,000	20,000	20,000	20,000	20,000	100,000
Undepreciated capital cost	400,000	80,000	80,000	80,000	80,000	80,000	400,000
Beginning of 2nd year -							
Disposal of asset No. 1 at \$100,000	100,000	80,000	-	-	-	-	20,000
Capital cost allowance - 2nd year	300,000	-	80,000	80,000	80,000	80,000	320,000
Undepreciated capital cost	60,000	-	16,000	16,000	16,000	16,000	64,000
Beginning of 3rd year -	240,000	-	64,000	64,000	64,000	64,000	256,000
Disposal of asset No. 2 at \$100,000	100,000	-	64,000	-	-	-	36,000
Capital cost allowance - 3rd year	140,000	-	-	64,000	64,000	64,000	192,000
Undepreciated capital cost	28,000	-	-	12,800	12,800	12,800	38,400
Beginning of 4th year -	112,000	-	-	51,200	51,200	51,200	153,600
Disposal of asset No. 3 at \$80,000	80,000	-	-	51,200	-	-	28,800
Capital cost allowance - 4th year	32,000	-	-	-	51,200	51,200	102,400
Undepreciated capital cost	6,400	-	-	-	10,200	10,200	20,400
Beginning of 5th year -	25,600	-	-	-	41,000	41,000	82,000
Disposal of asset No. 4 at \$45,000	45,000	-	-	-	41,000	-	4,000
Capital cost allowance - 5th year	19,400 1/	-	-	-	-	41,000	41,000
Undepreciated capital cost	-	-	-	-	-	8,200	32,800
Beginning of 6th year -	40,000 2/	-	-	-	-	32,800	7,200
Disposal of Asset No. 5 at \$40,000	40,000	-	-	-	-	-	-
Recapture at end of 6th year	(40,000)	-	-	-	-	-	-
Undepreciated capital cost	\$ -	-	-	-	-	-	-

Capital cost allowances minus profits on disposal	Year	Group Basis	Individual Asset Basis
1	1	\$100,000	100,000
2	2	60,000	44,000
3	3	28,000	2,400
4	4	6,400	(8,400)
5	5	(19,400)	4,200
6	6	(40,000)	(7,200)
		<u>\$135,000</u>	<u>135,000</u>

Notes:

1/ Subject to recapture of depreciation at end of 5th year.

2/ Subject to recapture of depreciation at end of 6th year.

TABLE 3-5

COMPARISON OF TREATMENT OF PROFITS AND LOSSES ON DISPOSAL OF FIXED ASSETS ON A GROUP BASIS WITH THE TREATMENT ON AN INDIVIDUAL ASSET BASIS USING REDUCING BALANCE METHOD AND ASSUMING CONTINUED LOSSES ON DISPOSAL

	Group Basis	Individual Asset Basis					Profit (Loss), on Disposal
		1	2	3	4	5	
Capital cost	\$500,000	100,000	100,000	100,000	100,000	100,000	500,000
Capital cost allowance - 1st year	100,000	20,000	20,000	20,000	20,000	20,000	100,000
Undepreciated capital cost	400,000	80,000	80,000	80,000	80,000	80,000	400,000
Beginning of 2nd year -							
Disposal of asset No. 1 at \$50,000	50,000	80,000	-	-	-	-	80,000
Capital cost allowance - 2nd year	350,000	-	80,000	80,000	80,000	80,000	320,000
Undepreciated capital cost	70,000	-	16,000	16,000	16,000	16,000	64,000
Beginning of 3rd year -	280,000	-	64,000	64,000	64,000	64,000	256,000
Disposal of asset No. 2 at \$50,000	50,000	-	64,000	-	-	-	64,000
Capital cost allowance - 3rd year	230,000	-	-	64,000	64,000	64,000	192,000
Undepreciated capital cost	46,000	-	-	12,800	12,800	12,800	38,400
Beginning of 4th year -	184,000	-	-	51,200	51,200	51,200	153,600
Disposal of asset No. 3 at \$40,000	40,000	-	-	51,200	-	-	51,200
Capital cost allowance - 4th year	144,000	-	-	-	51,200	51,200	102,400
Undepreciated capital cost	28,800	-	-	-	10,200	10,200	20,400
Beginning of 5th year -	115,200	-	-	-	41,000	41,000	82,000
Disposal of asset No. 4 at \$30,000	30,000	-	-	-	41,000	-	41,000
Capital cost allowance - 5th year	85,200	-	-	-	-	41,000	41,000
Undepreciated capital cost	17,200	-	-	-	-	8,200	8,200
Beginning of 6th year -	68,000	-	-	-	-	32,800	32,800
Disposal of asset No. 5 at \$20,000	20,000	-	-	-	-	32,800	32,800
Terminal loss allowed at end of 6th year	48,000	-	-	-	-	-	-
Undepreciated capital cost	48,000	-	-	-	-	-	-
	\$ -	-	-	-	-	-	-
Capital cost allowances plus losses on disposal	Group Basis	Individual Asset Basis					
1	\$100,000	100,000					
2	70,000	94,000					
3	46,000	52,400					
4	28,800	31,600					
5	17,200	19,200					
6	48,000	12,800					
	\$310,000	\$310,000					

disposal. In all three instances there are considerable differences in the annual deductions depending on the method used. It would appear, from the point of view of the taxpayer, that the treatment of profits on an individual asset basis would be undesirable since it would make recaptured depreciation subject to tax at an earlier date. The taxpayer would benefit from use of the individual asset basis when losses arise on the sale of fixed assets. As could be expected, in all three cases there would be no difference in the total deduction allowed over the six-year period.

Because of the generosity of the capital cost allowance rate, and the inflationary trend over the last fourteen years with the resultant increase in prices of depreciable property, business has generally experienced profits on sales of depreciable property, rather than losses. It would appear, therefore, that to date the present method of handling profits and losses for tax purposes has benefited the taxpayer.

Although it is suggested that the individual asset basis would likely result in a more accurate determination of income, it would, in effect, destroy the original purpose of depreciating assets by class—that is, the simplification of administration. No fewer records would be required to administer a system wherein capital cost allowances and profits and losses on disposal are treated on an individual asset basis rather than by class. The information required to administer either method would be relatively the same. The group method in this case seems to have worked for the benefit of both the taxpayer and the Department of National Revenue, although in extreme cases it could result in an anomalous situation.

The Canadian Institute of Chartered Accountants, in a submission to the Commission, have recommended that a taxpayer be allowed to make an

interim claim for terminal losses without disposing of all of the assets of one class and that such claim be to the extent that the undepreciated capital cost of the class exceeds the original capital cost of the remaining assets in that class at the end of the year. Such a provision would help to relieve the extreme situation which might arise, as illustrated in Table 3-2, and would likely be inexpensive to the Department of National Revenue.

Recapture. The recapture provision complements the feature discussed above, in that it assures that deductions in respect of the capital cost of depreciable property are limited to the proven cost of the property to the taxpayer. Allowances claimed in excess of the proven cost of individual assets (a) are used to offset losses on disposal of other assets in the same class; (b) reduce future allowances on other assets in the class; or (c) are taken into income to the extent that they exceed the undepreciated capital cost of assets remaining in the class. The problems arising from the grouping of assets in situations (a) and (b) were discussed above. Another problem arises when excess allowances are taken into income (i.e., recaptured).

It might be argued that the present recapture provisions in our capital cost allowance system operate as a capital gains tax in many instances. A portion of the proceeds from the sale of depreciable property (particularly if it has been retained for any length of time) often represents gains which reflect changes in the purchasing power of the monetary unit. Where total proceeds are less than original capital cost but more than undepreciated capital cost, and all the assets in the class have been sold, the excess of proceeds over undepreciated capital costs

will be included in income. Because a portion of this excess likely represents revaluation gains, the recapture provision operates as a capital gains tax in this instance.

Where the proceeds of disposal are deducted from the undepreciated capital cost of remaining assets in the class, the effect, although not as obvious, is the same. In this instance, the portion of the proceeds which represents revaluation gains reduces the undepreciated capital cost on which future allowances are calculated. The capital gains tax is here levied in the form of a reduction in deductions allowed against income in future years.

Simplicity

In addition to providing for the amortization of cost, the system was meant to be "a further step towards greater simplicity in our system of taxing business profits".

From the point of view of the government, this objective of the system has been fulfilled. The reducing balance method, with official maximum rates applying to groups of assets, has proven to be far simpler and more economical to administer than the previous system which consisted primarily of straight-line depreciation of individual assets.

For those taxpayers who elect to follow the tax method of depreciation in their accounts, the capital cost allowance system has offered the same advantages of simplicity and economy as it has to the government. Taxpayers who book depreciation on a different basis than that prescribed for tax purposes, however, will not likely find the capital cost allowance system to their advantage from the point of view of simplicity, because it

is necessary for those taxpayers to keep two sets of depreciation records—one for their accounts and one for tax purposes. Despite the fact that some taxpayers find it necessary to keep extra records because of the tax depreciation system, there appears to be almost unanimous acceptance of the present system by taxpayers.

ADEQUACY OF CAPITAL COST ALLOWANCES

The annual capital cost allowances deductible for tax purposes are considered by many taxpayers to be in excess of true depreciation on depreciable property. Until 1954, at which time it was rescinded, Regulation 1100(4) required the amount of capital cost allowance claimed for tax purposes to be booked as depreciation in the taxpayers' accounts. Taxpayers and their accounting advisers argued strenuously against the provisions of this regulation, basically, on the grounds that tax rules should not affect the determination of annual depreciation charges calculated in accordance with generally accepted accounting principles. This would strongly suggest that taxpayers did not consider that allowances calculated in accordance with the Income Tax Regulations necessarily represented a true measure of depreciation on property.

That this was so has been largely substantiated by events subsequent to the revocation of Regulation 1100(4). Immediately after its revocation, many taxpayers reversed that portion of the depreciation recorded in prior years which was in excess of true depreciation, and had been recorded only because of the tax requirement. From 1954 on, an increasing number of companies have followed the practice of booking depreciation in one amount while claiming capital cost allowances in another. This is illustrated in Tables 3-6 and 3-7 which present the depreciation treatment of Canadian

TABLE 3-6
COMPANIES CLAIMING C.C.A. IN ONE AMOUNT AND BOOKING DEPRECIATION IN ANOTHER

Year	Setting up a Deferred Credit for Future Taxes				Not Setting up a Deferred Credit for Future Taxes				Total				Companies Booking Depreciation in Same Amount as C.C.A. Claimed			
	S	M	L	Total	S	M	L	Total	S	M	L	Total	S	M	L	Total
1955	2	10	16	28	-	10	6	16	2	20	22	44	24	15	20	59
1956	2	10	18	30	-	12	7	19	2	22	25	49	24	13	17	54
1957	4	12	18	34	1	11	7	19	5	23	25	53	21	12	17	50
1958	4	12	18	34	1	12	8	21	5	24	26	55	21	11	16	48
1959	4	15	21	40	1	11	6	18	5	26	27	58	21	9	15	45
1960	5	18	23	46	2	8	8	18	7	26	31	64	19	9	11	39
1961	5	19	24	48	2	9	8	19	7	28	32	67	19	7	10	36
1962	4	20	24	48	2	8	8	19	6	29	32	67	20	6	10	36

TABLE 3-7
 PERCENTAGE OF COMPANIES IN SAMPLE CLAIMING C.C.A. IN ONE
 AMOUNT AND BOOKING DEPRECIATION IN ANOTHER

<u>Year</u>	<u>Small</u>	<u>Medium</u>	<u>Large</u>	<u>Total</u>
1955	8	57	52	43
1956	8	63	59	48
1957	19	66	59	51
1958	19	69	62	53
1959	19	74	64	56
1960	27	74	74	62
1961	27	80	75	65
1962	23	83	76	65

public companies, divided into large (assets over \$90 million), medium (assets from \$25 million to \$90 million) and small companies (assets from \$5 million to \$25 million). This and other information which follows is derived from a confidential survey of public corporations conducted by this Commission.

Because the survey was not complete at the time this study was finalized, the dates used herein will not necessarily agree exactly with the final results of the survey.

Nevertheless, the conclusions which have been drawn from the preliminary survey results, which made use of information from over 90% of the reporting companies included in the final survey statistics, are consistent with the final survey results.

The number of companies in the sample which booked their own depreciation (i.e., an amount other than allowed for tax purposes) increased from 44 in 1955 to 67 in 1962, an increase from 43% to 65% of the total sample. The increase was experienced in all size groupings in varying degrees—from 8% to 23% for small companies, from 57% to 83% for medium-sized companies, and from 52% to 76% for large companies. The proportion of companies booking their own depreciation in the large- and medium-sized groups was much higher than for the small companies (i.e., in 1962, 82% of medium-sized companies and 76% of large companies booked their own depreciation, compared to only 23% of small companies). This may partially be explained by the large- and medium-sized companies' need for detailed and relatively accurate cost records and, therefore, for more accurate measures of depreciation; smaller companies are able to control their costs through more informal procedures. In addition, depreciation as a cost may be less significant for the smaller companies.

That tax allowances have generally been in excess of depreciation booked is indicated in Table 3-8 which shows capital cost allowances claimed and depreciation booked for the same 103 companies. The annual excess of capital cost allowances claimed over depreciation booked increased from approximately \$147 million in 1954 to \$207 million in 1957 and dropped back to \$148 million in 1962. The peak in 1957 coincided with the peak in capital acquisitions (as can be expected) in the same year, as illustrated in Chart 3-10. The total accumulated excess for the sample is \$1,229 million of which \$1,067 million relates to large companies. It is interesting to note that total depreciation booked by companies in the sample in any size group did not exceed, or even equal, the total capital cost allowances claimed by these companies in any of the years from 1955 to 1962.

The relationship between depreciation booked and capital cost allowances claimed for companies in the sample is further illustrated in Charts 3-1 and 3-2. Chart 3-1 reflects the figures in Table 3-8, whereas Chart 3-2 reflects the same figures after deducting the figures for two companies which were removed from the sample because of their unduly large effect on the sample. With the removal of these two companies the difference between capital cost allowances claimed and depreciation booked for large companies in our sample is relatively uniform from 1955 to 1962.

The difference between depreciation booked and capital cost allowances claimed arises primarily from the differences in principles used in the determination of book depreciation and the rules used to calculate capital cost allowances.

TABLE 3-8
ANNUAL DEPRECIATION BOOKED AND CAPITAL COST ALLOWANCES CLAIMED BY COMPANIES IN SURVEY 1955 TO 1962
(millions of dollars)

Year	Large Companies			Medium Companies			Small Companies			Total		
	C.C.A.	Depreciation	Difference	C.C.A.	Depreciation	Difference	C.C.A.	Depreciation	Difference	C.C.A.	Depreciation	Difference
1955	\$441.144	300.137	141.007	58.197	51.898	6.299	3.923	3.734	.189	503.264	355.769	147.495
1956	499.051	331.233	167.818	63.465	55.138	8.328	4.664	4.407	.257	567.180	390.778	176.403
1957	555.885	362.847	193.038	69.371	55.333	14.038	5.241	4.545	.696	630.497	422.725	207.772
1958	472.906	374.236	98.670	83.302	57.860	25.442	5.783	4.853	.930	561.991	436.949	125.042
1959	551.308	438.466	112.842	88.236	61.542	26.694	5.643	4.861	.782	645.187	504.869	140.318
1960	556.206	439.384	116.822	92.860	64.765	28.095	7.352	5.955	1.417	656.418	510.084	146.334
1961	567.015	456.761	110.254	93.540	67.826	25.714	7.075	5.413	1.662	667.630	530.000	137.630
1962	616.714	489.381	127.333	90.044	70.253	19.790	7.275	5.758	1.517	714.033	565.392	148.640
	<u>\$4,260.229</u>	<u>3,192.445</u>	<u>1,067.784</u>	<u>639.015</u>	<u>484.615</u>	<u>154.400</u>	<u>46.956</u>	<u>39.506</u>	<u>7.450</u>	<u>4,946.200</u>	<u>3,176.566</u>	<u>1,229.634</u>

Figures may not add due to rounding.

Chart 3-1

ANNUAL DEPRECIATION BOOKED AND CAPITAL COST ALLOWANCES CLAIMED BY COMPANIES IN SURVEY

Millions of Dollars
Ratio Scale

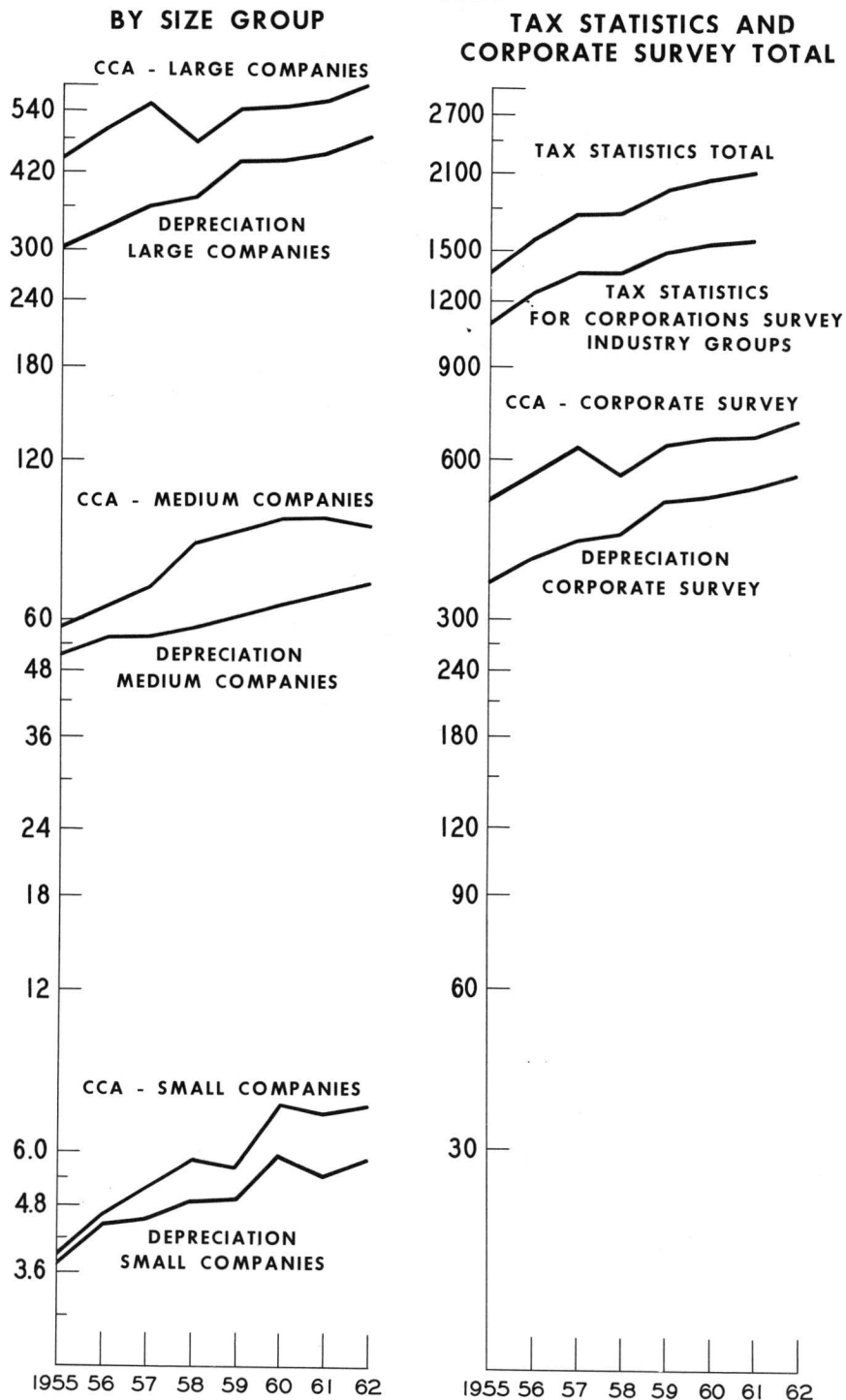
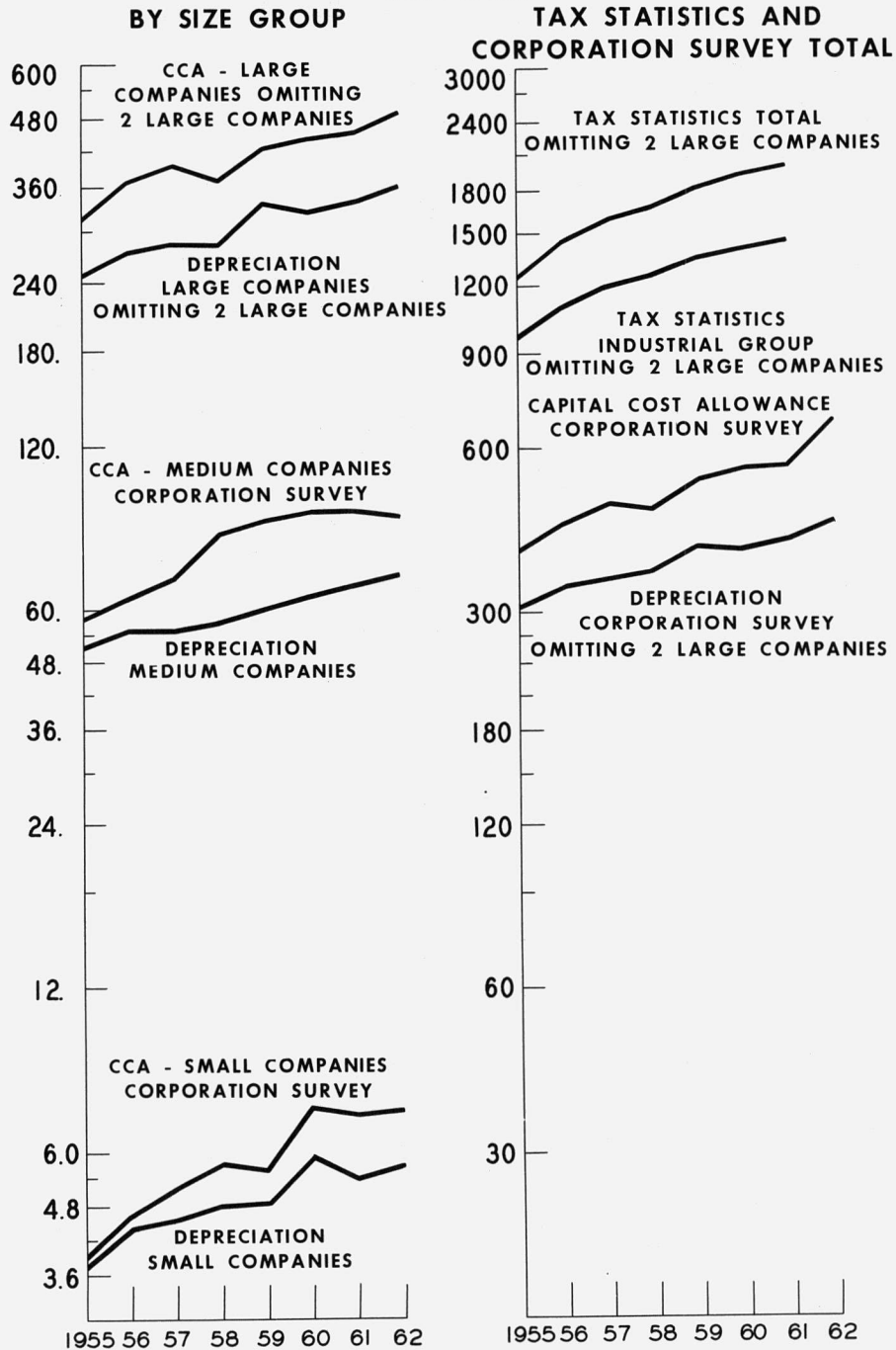


Chart 3-2

ANNUAL DEPRECIATION BOOKED AND CAPITAL COST ALLOWANCES CLAIMED BY COMPANIES IN SURVEY EXCLUSIVE OF 2 LARGE COMPANIES

Millions of Dollars
Ratio Scale



Method of Computing Depreciation

The Income Tax Regulations require that the majority of depreciable property be depreciated on the declining balance method, whereas taxpayers, on their own books, may use one of several methods (e.g., declining balance, straight-line, sum of the digits). The methods most often used by businessmen are described briefly in Chapter 4. Of these, the straight-line method seems to be the most popular.

That many taxpayers consider the maximum capital cost allowance claimed for tax purposes in the early years of the useful life of depreciable property to result in a temporary tax saving is evidenced by the number of taxpayers setting up a deferred income tax liability, as recommended by the Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants 1/ in Bulletin 10 (September 1954). The Committee recommended that,

...where the taxes payable for any year have been calculated after claiming capital cost allowances that are materially different from the depreciation recorded in the accounts, the financial statement should show:

- (a) the extent to which the taxes otherwise payable for the year were thereby reduced or increased, and,
- (b) the net accumulated amount by which taxes otherwise payable have been so reduced in the year under review and previous years.

The Committee suggests that these figures be either reflected directly in the financial statements or set out in an exploratory note thereto. As can be seen from Table 3-6, the number of companies in our sample setting up a deferred credit for future taxes on their financial statements increased from 28 in 1955 to 48 in 1962. Still others in the sample disclosed the same information by way of note.

The Supreme Court of British Columbia has recently supported the C.I.C.A. recommendation with regard to deferred tax credits. 2/ The question before the court was whether, for purposes of valuation, a deferred tax credit was, in fact, a liability (contingent or otherwise) or part of shareholders' equity. The court decided that the credit was not part of shareholders' equity, agreeing with accounting evidence given that it was a liability.

The following illustrations taken from an academic thesis on depreciation by R. Mendels, a member of the staff of the Royal Commission on Taxation, help to indicate the effect of a declining balance method of depreciation for tax purposes on a taxpayer's income tax liability. The difference between the rates used in the illustration and the rates provided by the Capital Cost Allowance Regulations will not affect the conclusion to be drawn from the examples given.

Table 3-9 and Charts 3-3 and 3-4 show the relationship between straight-line depreciation and maximum capital cost allowances on a single addition to fixed assets (the only one of its class). The allowances under either method are the same over a ten-year period if the asset is disposed of because of the terminal loss available for tax purposes. The tax saving (assuming the taxpayer is booking the correct depreciation), 3/ up to the fourth year equals the additional tax cost from the fourth year to the end of the estimated useful life of the asset. There is no tax saving over the life of the asset except for the time discount factor, 4/ and the possibility of a change in tax rates. As to the former, it should be noted that, although there is no saving in terms of taxes paid over the period of ten years, the present value of the tax saving from the first to fourth years will exceed

TABLE 3-9

TAX SAVING: SINGLE INVESTMENT OUTLAY

Asset Cost \$100

Capital Cost Allowance Rate: 25%; Straight-Line Depreciation: 10%

<u>Year</u>	<u>Capital Cost Allowance</u>	<u>Depreciation</u>	<u>Tax Saving at a 50% Tax Rate</u>	<u>Cumulative Tax Saving</u>
1	\$ 25.00	10.00	7.50	7.50
2	18.75	10.00	4.38	11.88
3	14.06	10.00	2.03	13.91
4	10.55	10.00	.28	14.19
5	7.91	10.00	(1.05)	13.14
6	5.93	10.00	(2.03)	11.11
7	4.45	10.00	(2.78)	8.33
8	3.34	10.00	(3.33)	5.00
9	2.50	10.00	(3.75)	1.25
10	<u>7.50*</u>	<u>10.00</u>	<u>(1.25)</u>	<u>-0-</u>
TOTAL:	<u>\$100.00</u>	<u>100.00</u>	<u>-0-</u>	<u>-0-</u>

*/ Terminal loss.

tax costs from the tenth year on will not offset the tax saving realized up to the ninth year, even ignoring the time discount factor.

Under these conditions, it is wrong to assume that a faster capital cost allowance write-off of the depreciable property during the early years will result in an increased tax liability later on. Although it is true that for a particular asset, the decreasing capital cost allowance will result in a higher effective tax rate, the continuous addition of new assets and the higher initial deductions allowable thereon defer the total reversal of the tax saving indefinitely.

Chart 3-3
TAX SAVING: SINGLE INVESTMENT OUTLAY
Asset Cost \$100
Capital Cost Allowance Rate: 25%; Straight-line Depreciation: 10%

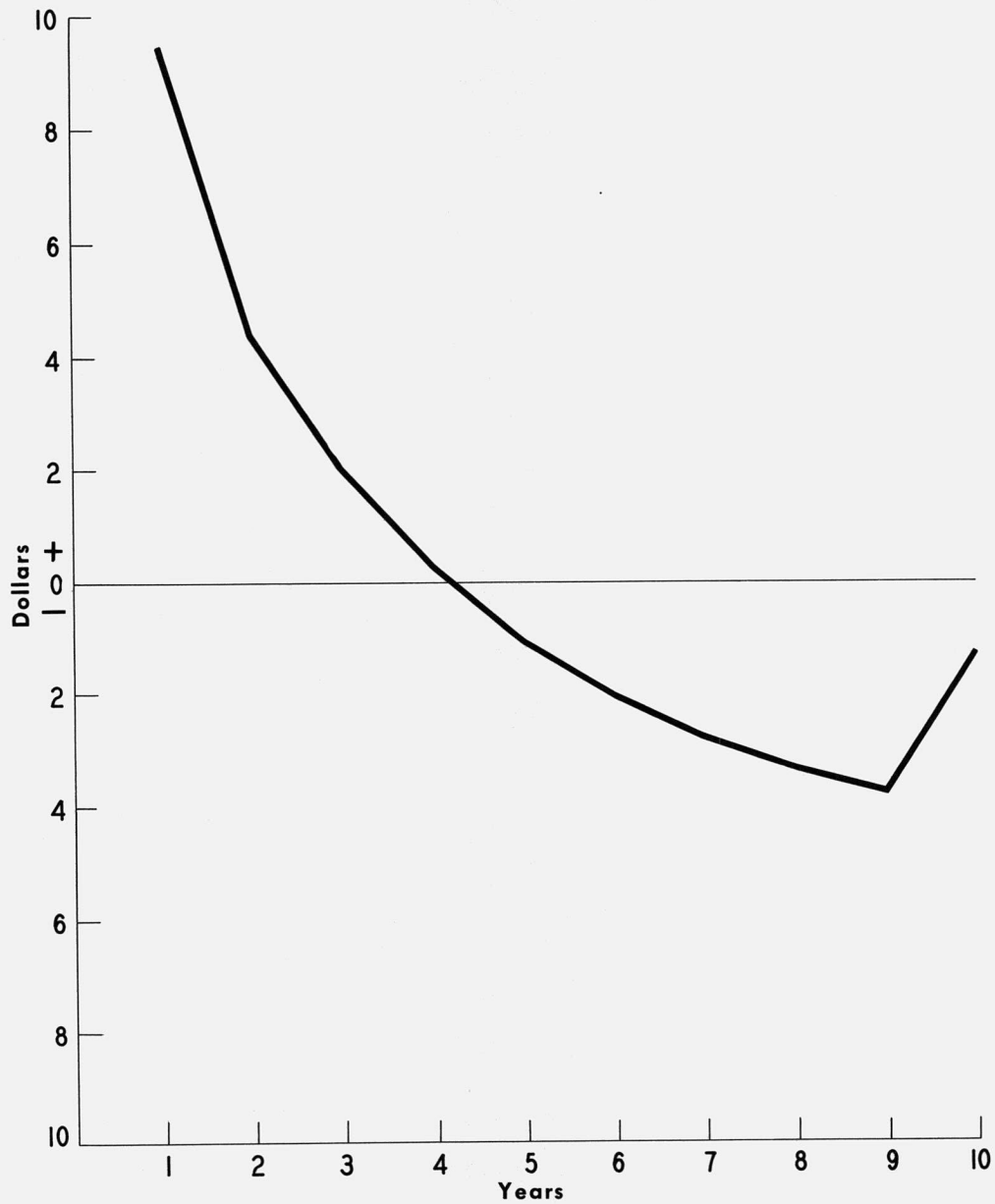
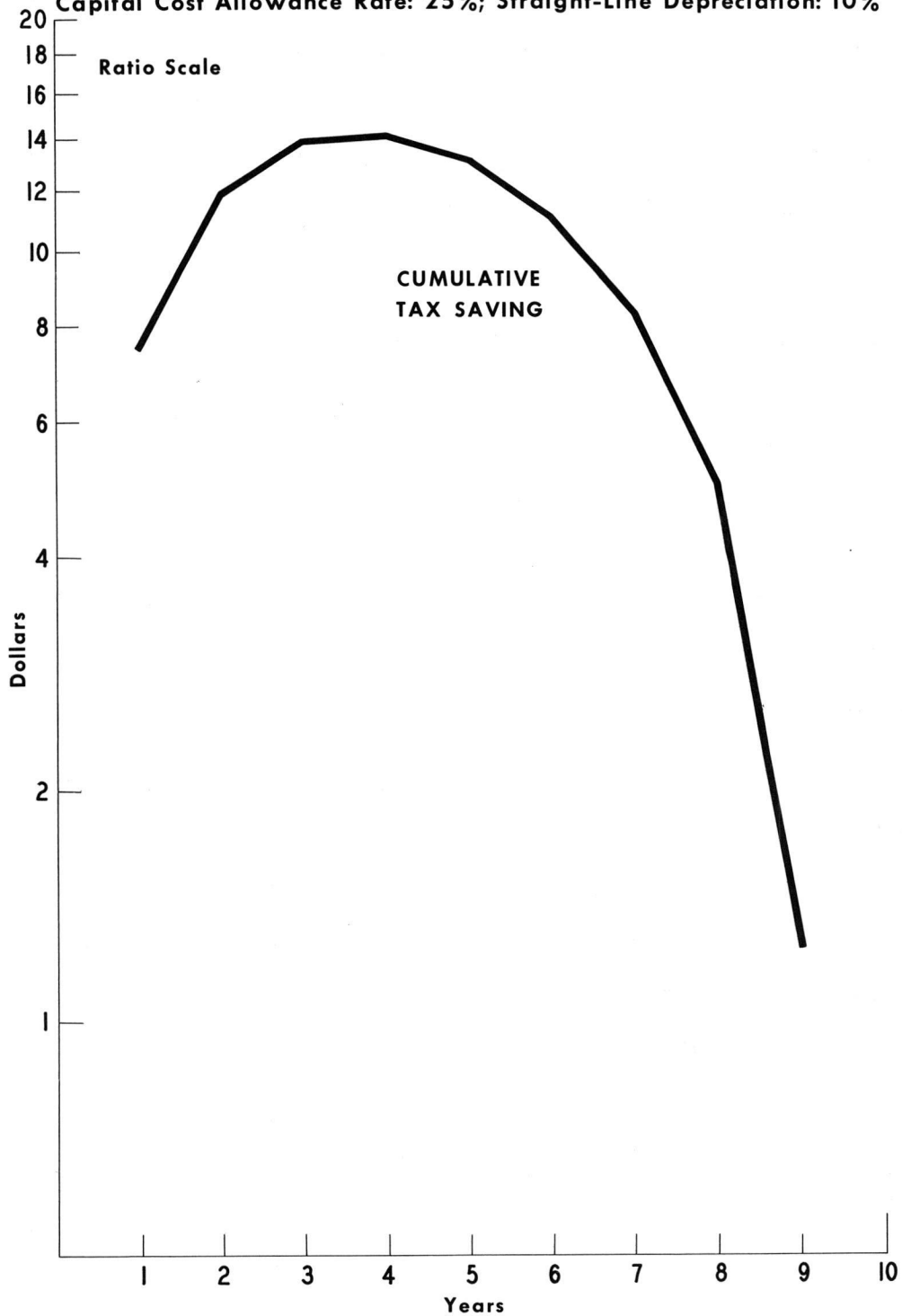


Chart 3-4

TAX SAVING: SINGLE INVESTMENT OUTLAY

Asset Cost \$100

Capital Cost Allowance Rate: 25%; Straight-Line Depreciation: 10%



the present value of the additional tax cost from the fourth to tenth years. This fact gives rise to the charge that the accelerated recovery of capital costs allowed for tax purposes results in "interest-free loans" from the government to taxpayers investing in depreciable property which are not available to other taxpayers. To the extent that this is true, the capital cost allowance system would appear to extend a tax incentive to those taxpayers making use of depreciable property in their businesses.

The example in Table 3-9 deals with a single investment of \$100. A different situation arises when the taxpayer keeps investing the same amount each year. In this case the taxpayer has a permanent tax saving, and there will never be a total reversal of the original saving realized. Although there is some reversal after the ninth year, this reduces steadily in amount each subsequent year and tends to level off close to zero after approximately twenty years. Certainly, the total additional tax costs from the tenth year on will not offset the tax saving realized up to the ninth year, even ignoring the time discount factor.

Under these conditions, it is wrong to assume that a faster capital cost allowance write-off of the depreciable property during the early years will result in an increased tax liability later on. Although it is true that for a particular asset, the decreasing capital cost allowance will result in a higher effective tax rate, the continuous addition of new assets and the higher initial deductions allowable thereon defer the total reversal of the tax saving indefinitely.

A third and different situation exists where a taxpayer acquires depreciable property at a geometric rate of growth. In this case, perhaps

the most realistic of the three, the total tax saving will continue to grow. Table 3-11 and Charts 3-7 and 3-8 show that after the tenth year, when the first investment has been completely written off, the tax saving begins to increase again.

In the example, the taxpayer started with zero investment and, thus the fluctuation in tax saving. If the taxpayer had owned depreciable property in the first year, the tax saving would have been uniform in the example as from the tenth year. This indicates the advantages which accrue to new businesses because of the generous rates of capital cost allowance available. The greater the difference between the capital cost allowance rate and the rate of depreciation used on the books, and the faster the rate of acquisition of depreciable property by the taxpayer, the greater the amount of tax saving and the faster the rate of increase in tax saving will be. According to R. Mendels, the ratio of capital cost allowance to booked depreciation and the tax saving will stabilize at some level which depends upon the rate of growth of acquisition of depreciable property (e.g., at a rate of growth of 5%, a capital cost allowance of 25%, and a straight-line depreciation rate of 10%, capital cost allowances will ultimately stabilize at a level of 32% above booked depreciation).

The foregoing illustrations will help to interpret the results of our corporate survey.

In looking at the estimated tax saving of companies in our survey, we will confine our comments to the large- and medium-sized companies

TABLE 3-10

TAX SAVING: CONSTANT INVESTMENT OUTLAY

New Investment of \$100 per Year

Capital Cost Allowance Rate: 25%; Straight-Line Depreciation: 10%

<u>Year</u>	<u>Capital Cost Allowance</u>	<u>Depreciation</u>	<u>Tax Saving at a 50% Tax Rate</u>	<u>Cumulative Tax Saving</u>
1	\$ 25.00	10.00	7.50	7.50
2	43.75	20.00	11.87	19.37
3	57.81	30.00	13.90	33.27
4	68.36	40.00	14.18	47.45
5	76.27	50.00	13.13	60.58
6	82.20	60.00	11.10	71.68
7	86.65	70.00	9.32	81.00
8	89.99	80.00	4.99	85.99
9	92.49	90.00	1.24	87.23
10	94.37	100.00	(2.81)	84.42
11	95.78	100.00	(2.11)	82.31
12	96.83	100.00	(1.59)	80.72
13	97.63	100.00	(1.19)	79.53
14	98.22	100.00	(.89)	78.64
15	98.66	100.00	(.67)	77.97
16	99.00	100.00	(.50)	77.47

Chart 3-5

TAX SAVING: CONSTANT INVESTMENT OUTLAY

New Investment of \$100 per year

Capital Cost Allowance Rate: 25%; Straight-line Depreciation: 10%

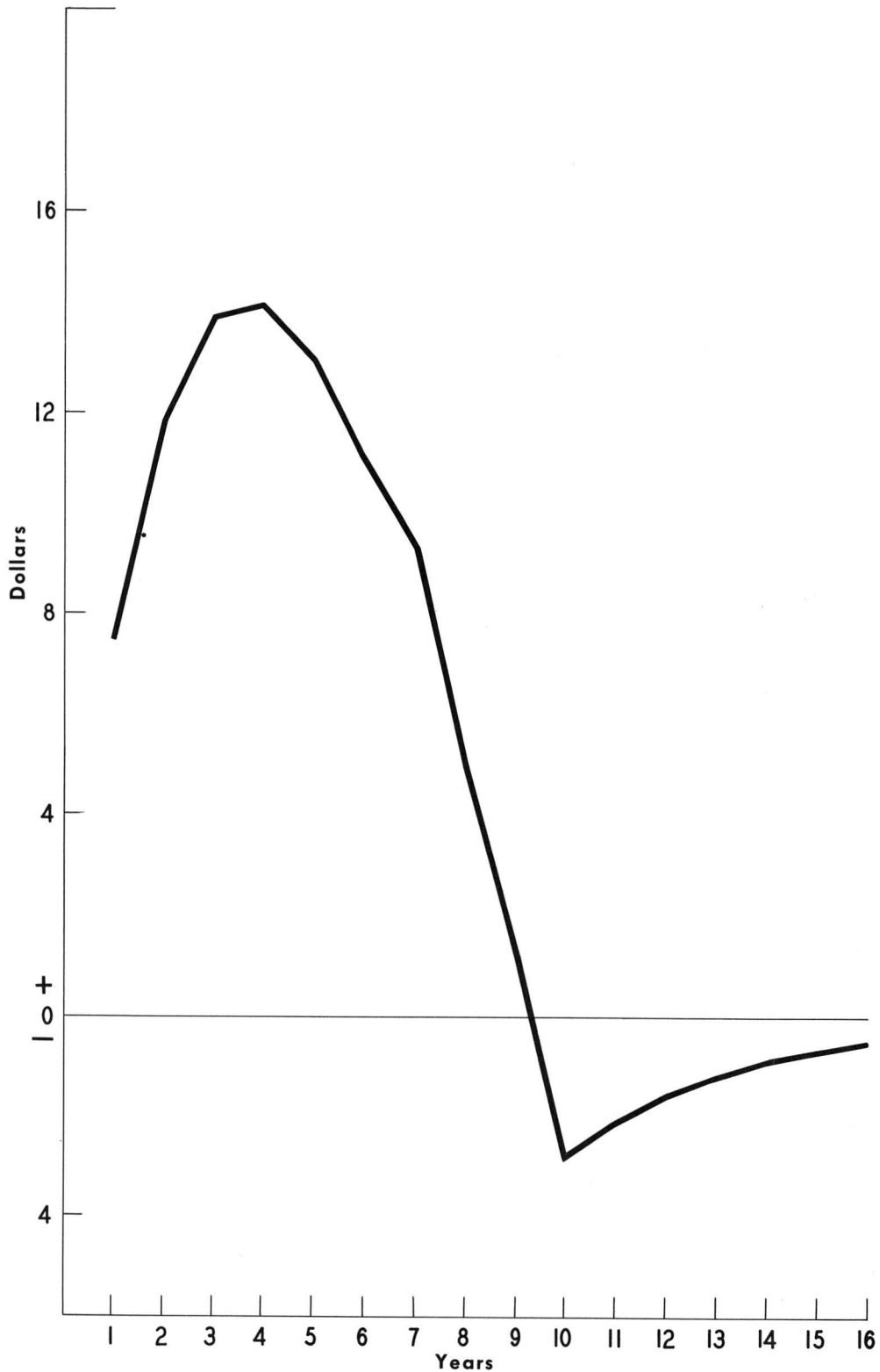


Chart 3-6

CUMULATIVE TAX SAVING : CONSTANT INVESTMENT OUTLAY

New Investment of \$100 per Year

Capital Cost Allowance Rate: 25%; Straight-line Depreciation: 10%

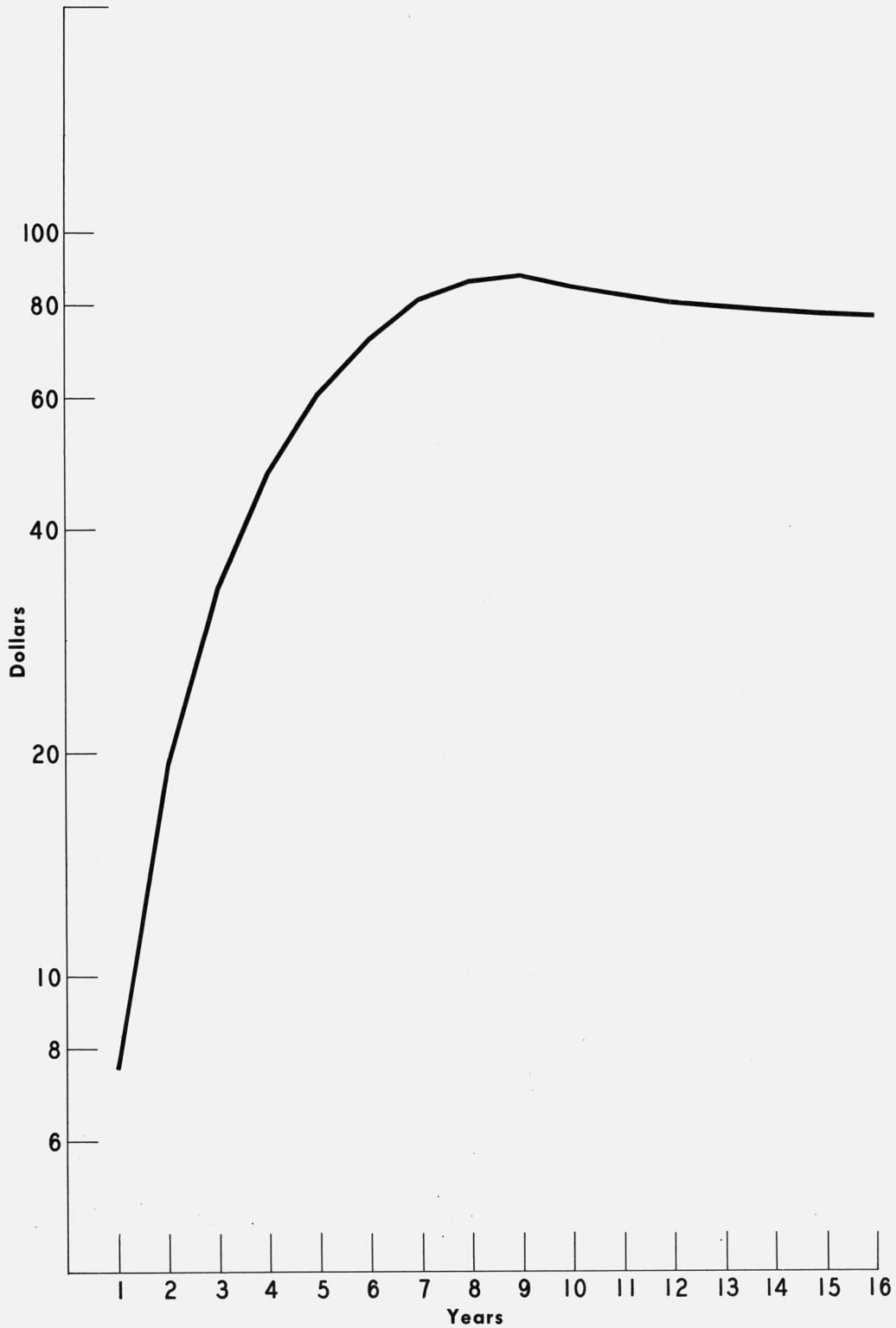


TABLE 3-11

TAX SAVING: INCREASED INVESTMENT OUTLAYS

Annual Rate of Capital Expansion: 6%

Capital Cost Allowance Rate: 25%; Straight-Line Depreciation: 10%

<u>Year</u>	<u>Annual Investment</u>	<u>Capital Cost Allowance</u>	<u>Depreciation</u>	<u>Tax Saving at a 50% Tax Rate</u>	<u>Cumulative Tax Saving</u>
1	\$100.00	25.00	10.00	7.50	7.50
2	106.00	45.25	20.60	12.32	19.82
3	112.36	62.03	31.84	15.10	34.92
4	119.10	76.30	43.75	16.27	51.19
5	126.25	88.78	56.37	16.20	67.39
6	133.82	100.04	69.75	15.14	82.53
7	141.85	110.50	83.94	13.28	95.81
8	150.36	120.46	98.97	10.74	106.55
9	159.38	130.19	114.91	7.64	114.19
10	168.95	139.88	131.81	4.03	118.22
11	179.08	149.68	139.72	4.98	123.20
12	189.83	159.72	148.10	5.81	129.01
13	201.22	170.09	156.98	6.55	135.56
14	213.29	180.89	166.40	7.24	142.80
15	226.09	192.19	176.39	7.90	150.70

Chart 3-7

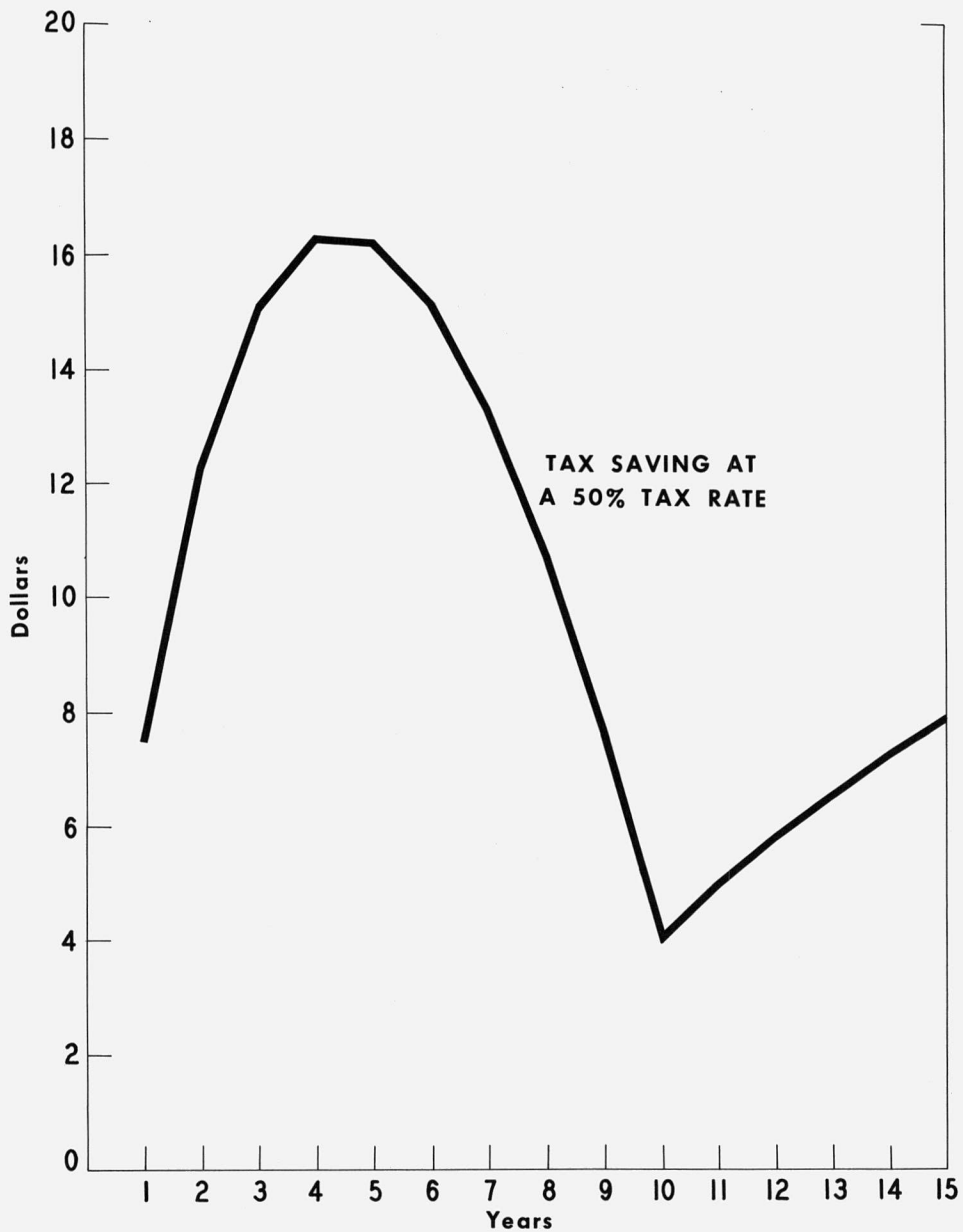
TAX SAVING : INCREASED INVESTMENT OUTLAYS**ANNUAL RATE OF CAPITAL EXPANSION : 6%****Capital Cost Allowance Rate : 25%; Straight-Line Depreciation : 10%**

Chart 3-8

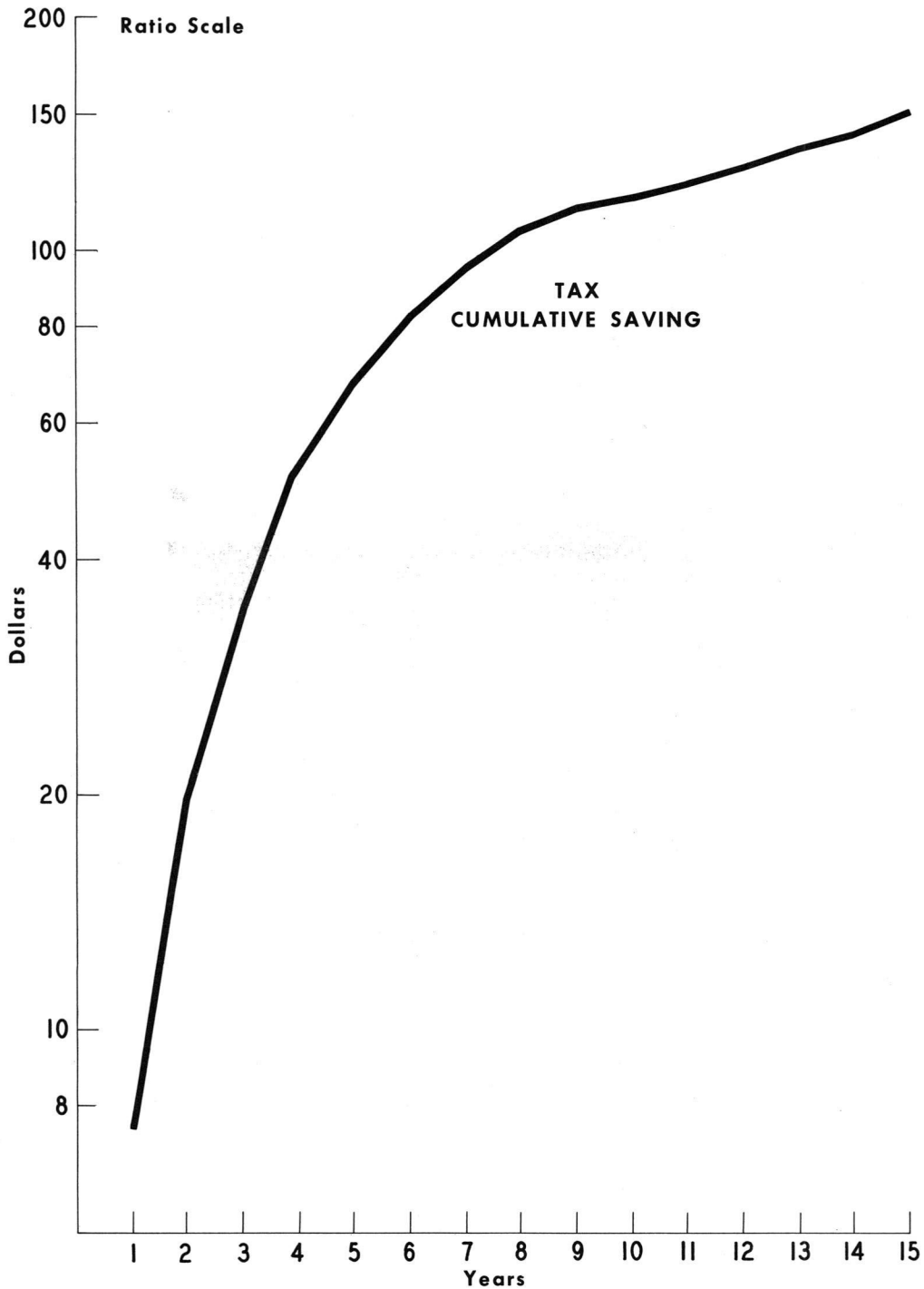
TAX SAVING : INCREASED INVESTMENT OUTLAYS**ANNUAL RATE OF CAPITAL EXPANSION : 6%****Capital Cost Allowance Rate : 25%; Straight-Line Depreciation : 10%**

TABLE 3-12

CUMULATIVE TAX SAVING: COMPANIES IN CORPORATE SURVEY BOOKING DEPRECIATION
IN AN AMOUNT OTHER THAN CLAIMED FOR TAX PURPOSES

Year	LARGE				MEDIUM			
	Constant Sample -		All Companies -		Constant Sample -		All Companies -	
	20 Companies		From 22 in 1955		18 Companies		to 29 in 1962	
	Millions of Dollars	Percentage of Prior Year	Millions of Dollars	1955	Millions of Dollars	Percentage of Prior Year	Millions of Dollars	1955
1955	147.848	-	183.388	100	12.248	-	100	12.585
1956	203.360	137	257.614	137	14.108	115	115	15.428
1957	261.275	128	340.643	177	18.090	128	148	22.859
1958	305.814	117	411.599	207	25.880	143	211	30.837
1959	364.947	119	480.698	247	33.079	128	270	40.421
1960	418.279	115	553.946	283	40.779	123	333	50.272
1961	461.009	110	625.141	312	48.995	120	400	60.959
1962	484.958	105	687.080	328	56.946	116	465	74.338

TABLE 3-13
ANNUAL CAPITAL ACQUISITIONS
1955-62

(millions of dollars)

Year	Large		Medium		
	Constant Sample <u>20 Companies</u>	All Companies in Survey - <u>42 Companies</u>	Constant Sample <u>18 Companies</u>	All Companies in Survey - <u>35 Companies</u>	All Companies in Survey - <u>103 Companies</u>
1955	\$354.403	678.308	35.565	58.913	742.387
1956	462.116	912.754	86.472	130.220	1,050.764
1957	574.381	1,026.942	70.383	137.177	1,176.563
1958	432.380	801.456	65.768	103.231	916.990
1959	441.787	849.999	56.357	95.568	954.196
1960	394.196	925.685	53.375	97.176	1,038.055
1961	301.711	843.071	56.092	99.134	954.589
1962	385.148	901.732	76.393	118.483	1,020.769

Chart 3-9
**CUMULATIVE TAX SAVING COMPANIES
 IN CORPORATE SURVEY BOOKING
 DEPRECIATION IN AN AMOUNT
 OTHER THAN CLAIMED FOR TAX PURPOSES**

Millions of Dollars
 Ratio Scale

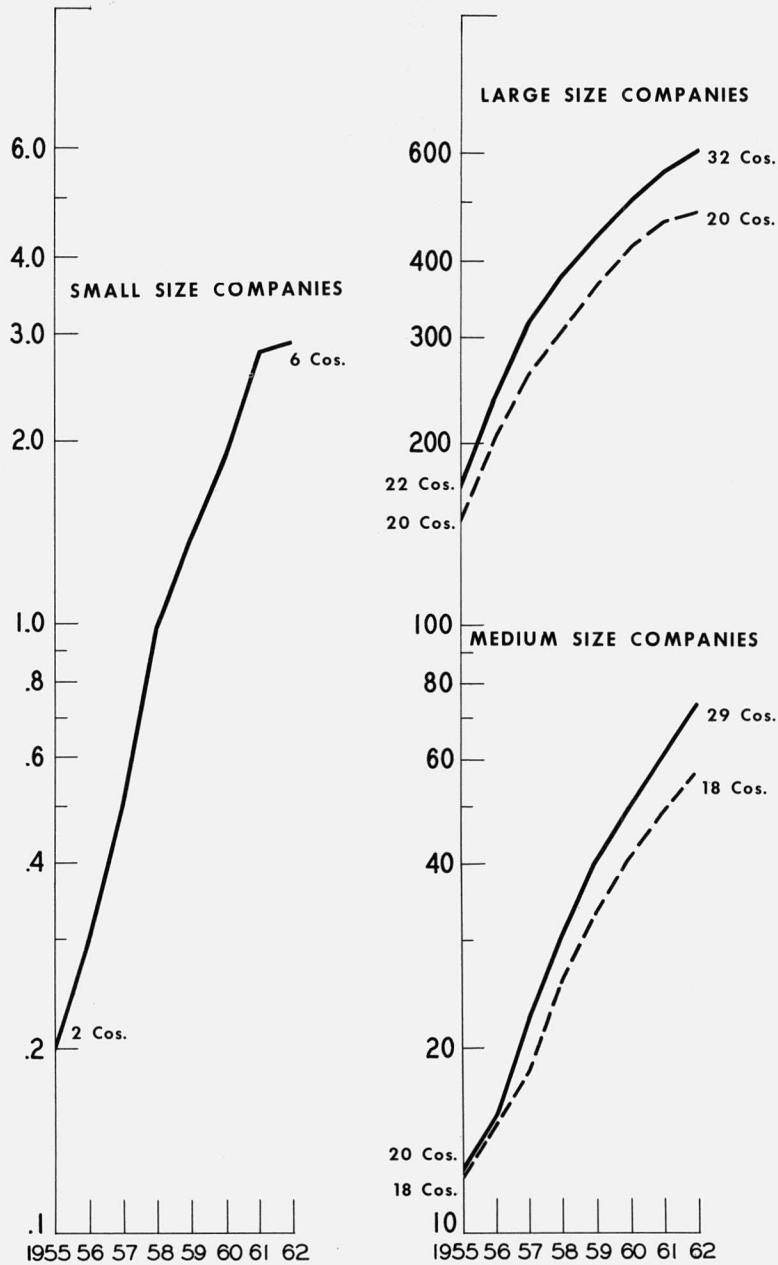
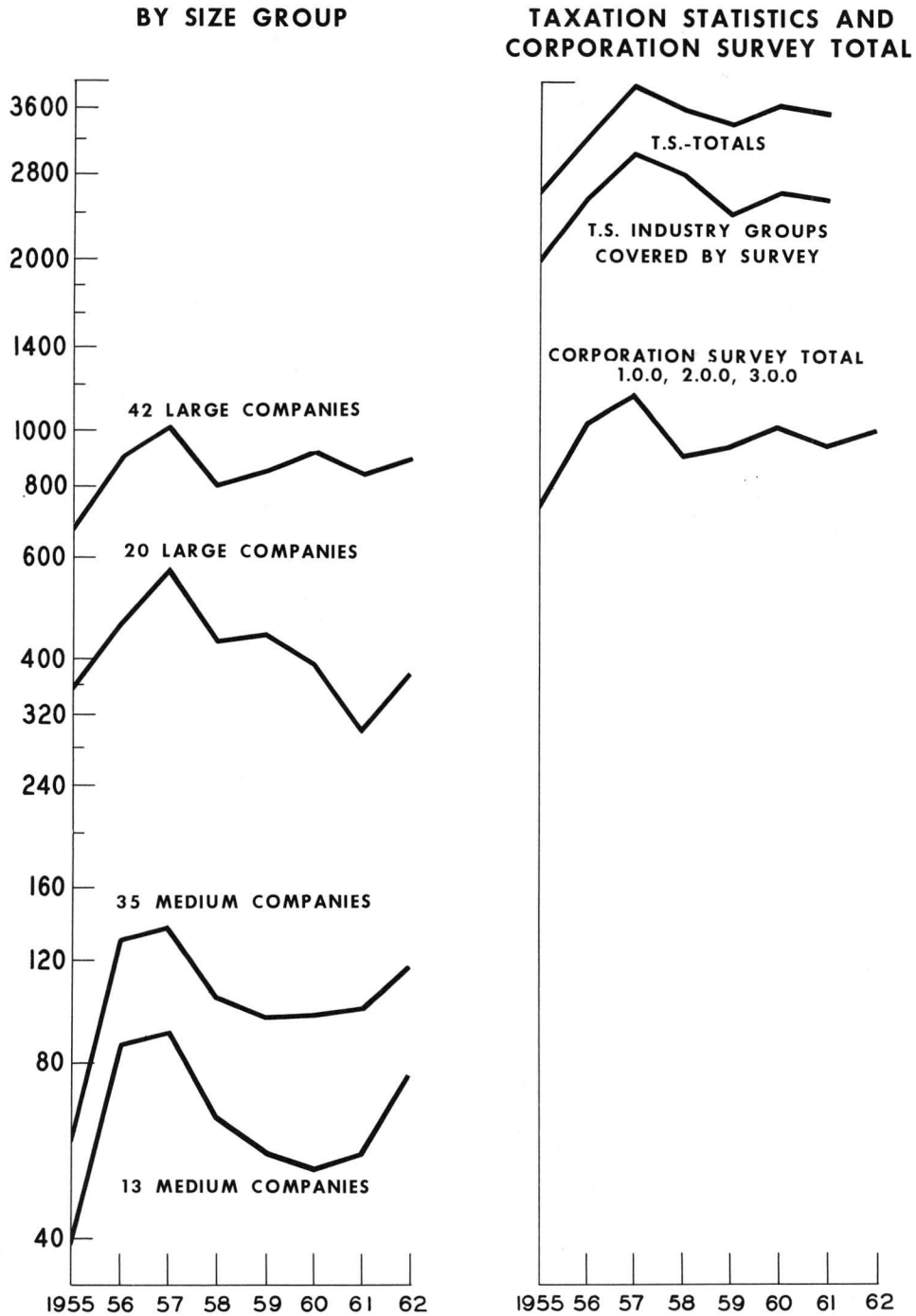


Chart 3-10
CAPITAL ACQUISITIONS
 Millions of Dollars
 Ratio Scale



which book depreciation in an amount other than claimed for tax purposes. The assumption is that these companies are in the best position to determine true depreciation on their property and to measure it. Small companies in the corporate survey are not considered because the number of such companies in the survey does not constitute an adequate sample. In addition to looking at the total estimated tax savings of all companies using their own depreciation methods regardless of when they began this practice, we will look at the figures for those companies which have constantly booked their own depreciation over the eight-year period of the survey in order to eliminate the effects of companies converting to a depreciation method other than required for tax purposes during the period under study.

Table 3-12 and Chart 3-9 show the estimated tax saving for large- and medium-sized companies which (a) booked their own depreciation in each of the years from 1955 to 1962, and (b) all companies booking their own depreciation regardless of the year they began to do so. In examining the rate of growth in tax saving the constant sample is the more significant since it eliminates the effects of companies beginning to use their own depreciation methods during the period under examination.

Both Table 3-12 and Chart 3-9 indicate that the twenty large companies and eighteen medium-sized companies have continued to realize tax savings by claiming capital cost allowances in excess of depreciation booked. The picture is comparable to that in Table 3-11

and Chart 3-7 where there is no reversal of tax saving because of continuous capital expansion. Although the rate of increase in tax saving is gradually reducing (e.g., in large companies from 137% of the prior year in 1956 to 105% of the prior year in 1962), there is little indication that there will be any reversal of tax savings in the near future. Any more definite conclusions as to the future trend would require considerably more information than is available at present.

Table 3-13 and Chart 3-10 show the capital expenditures for the corporate survey and total large- and medium-sized companies within the survey. In addition, the acquisitions of the same twenty large- and eighteen medium-sized companies, illustrated in Table 3-12 and Chart 3-9, are shown for comparison purposes. Comparable figures from the taxation statistics are also shown on Chart 3-10.

Table 3-13 and Chart 3-10 explain the behaviour of the tax saving function in Table 3-12 and Chart 3-9. Although the rate of capital expansion has not been uniform over the eight-year period, the expenditure in each year has exceeded the first year, that of 1955. With such capital expenditures it is obvious from Tables 3-10 and 3-11 and Charts 3-5 and 3-7 that the tax saving will tend to be permanent. Even with some reversal of this tax saving in the future, which is doubtful, the interest on the saving over a period of years will be quite substantial.

Economic Incentives

As indicated in Chapter 2, the government has used the capital cost allowance system to attempt to influence desired areas of the economy. The additional capital cost allowances over and above the normal rate originally provided for in the Regulations, which are accorded to certain taxpayers through these incentive measures, are not normally recognized as depreciation in good accounting practice. These additional allowances, therefore, have increased the spread between allowances claimed for tax purposes and depreciation booked in companies' accounts. As such, they are a factor which contributes to the tax saving illustrated above.

Grouping of Assets

The Regulations governing the capital cost allowance system require that assets be grouped into relatively broad classifications (at the time of writing, March 1965 there are twenty-three different classes). Although these classifications were supposedly designed to group assets of relatively equal life expectancies, the principle of depreciating on a class basis, as opposed to an individual asset basis, tends to produce a difference between tax depreciation and book depreciation where the taxpayer does not group, or groups differently. Possible inequities produced by the group method are discussed later in this chapter.

Capital Cost Allowances on Assets Not in Use

The tax Regulations allow capital cost allowances to be claimed before an asset is actually in use. As indicated previously, accepted

financial accounting practice in these circumstances would not permit depreciation to be booked until such time as the asset became useful to the business. Consequently, this also tends to add to the difference between capital cost allowances claimed and depreciation booked.

Retention of Profits and Losses
in Undepreciated Capital Costs

The tax Regulations provide for the retention of any profit or loss on the sale of a fixed asset in the undepreciated capital cost of the class, whereas this profit or loss would be written off on the books of the taxpayer at the time of disposal. The amount retained in undepreciated capital costs for tax purposes continues to be claimed in the form of capital cost allowances, whereas no further depreciation is likely to be recorded on the books of the taxpayer (i.e., if the taxpayer is not on a group basis). Again, this difference tends to add to the spread between capital cost allowances claimed and depreciation booked.

Allowance Claimed at
Taxpayer's Discretion

A factor which might tend to make the capital cost allowance less than the depreciation booked is the taxpayer's privilege of claiming any amount of capital cost allowance from nil up to the maximum rate provided by the Regulations. Such an option is not available to taxpayers in recording depreciation in their own accounts. This permissive aspect of the capital cost allowance system provides a convenient means whereby taxpayers may circumvent the loss-carry-forward provisions of the Act. Although losses may be carried forward for a period of five years under section 27(1)(e), this period is often effectively extended by deferring

the claim for capital cost allowances until such times as such allowances may be deducted from profits. This may be done for an indefinite period.

The taxpayer's discretion in claiming allowances may also be used to take advantage of the dual rate of corporate tax. Thus, a taxpayer may claim only enough allowance to reduce his income to an amount on which only the lower rate of tax is charged, thereby deferring allowances to do the same in following years. The possibility of manipulating income subject to tax in this manner is open more to capital-intensive businesses (i.e., those businesses with significant amounts of depreciable property), than to labour-intensive businesses. The latter must claim their labour costs in the year they are incurred. The permissive nature of the capital cost allowance system would, therefore, appear to create an inequity in this respect.

All of the foregoing factors affect the difference between capital cost allowances claimed for tax purposes and depreciation booked in taxpayers' accounts. However, the most significant factor would appear to be the basic method of depreciation required for tax purposes which results in higher allowances in the earlier years of the life of an asset and lower allowances in the later years.

COMPARISON WITH CURRENT ACCOUNTING PRACTICE

The following is a comparison of the principles of the present capital cost allowance system with current accounting practice.

Similarities

1. For the first time the Act has given positive recognition to depreciation as an expense of earning income. This has long been recognized in financial accounting.

2. The change in emphasis from wear and tear depreciation to one of amortization of cost recognizes the prevailing view that the basic purpose of depreciation accounting is the write-off of the cost of a fixed asset in the determination of income.
3. The reducing balance method required for tax purposes is one of several generally accepted methods of allocating costs of fixed assets. There is a body of opinion that believes that this method best measures the contribution that any capital asset makes to the income-earning process.
4. The grouping of assets into classes is acceptable provided that assets so grouped have reasonably equivalent useful life expectancies. The method simplifies the calculation of depreciation and has been used in financial accounting for some time.
5. The recapture provision in the capital cost allowance system assures that total depreciation claimed for tax purposes does not exceed proven costs to the taxpayer. This corresponds to the financial accounting treatment of depreciation based on cost to the taxpayer.

Departures

1. Although the reducing balance method is a generally accepted accounting method of calculating depreciation, it is only one of several alternatives (see Chapter 4). The mandatory use of this method for tax purposes was one of the main sources of complaint by businessmen and their advisors when the system was first introduced because the method is not accepted as being appropriate in many cases. This situation was aggravated by the requirement

that taxpayers, in order to claim maximum allowable deductions for tax purposes, were required to record the same amount in their accounts. Since the repeal of this requirement the criticism of the tax method appears to have subsided. Businessmen now realize that the mandatory reducing balance method for tax purposes is a tax Regulation only, and need not affect good accounting treatment of depreciation in their accounts.

The fact that the reducing balance method is not universally acceptable is pointed up in an editorial comment in the Canadian Tax Reporter.

...the present method of computing "depreciation" allowances for income tax purposes differs so widely from the normal methods used by taxpayers in keeping their books of account, that it is quite possible that the amount of depreciation shown in a taxpayer's books may vary considerably from the amount of capital cost allowance which he may take for tax purposes, and accordingly, the "undepreciated balance" of assets on the taxpayer's books may not tally at all with the "undepreciated capital cost" outstanding for tax purposes. 5/

It is a fact that for many taxpayers there is a considerable spread between capital cost allowances claimed and depreciation booked which is evidenced by the deferred income tax liability appearing on many balance sheets. In most instances, the taxpayer is able to reduce his taxes by claiming more capital cost allowance than he would charge in his accounts as depreciation.

2. Although obsolescence is recognized, and eventual amortization of virtually all costs is assured through the present system, the practice of retaining losses on disposal in undepreciated capital costs and the deduction therefrom of profits on disposal is a tax

concept only, and is contrary to generally accepted accounting principles. 6/

3. Taxpayers may claim any amount of capital cost allowance from nil to the maximum rates provided for the various categories into which assets may be classified. There may be many factors influencing his decision to claim all or none of the permitted allowances, the least of which may be the practical consideration of the real depreciation suffered on property used during the year. 7/

Although there was once a tendency to vary annual depreciation charges according to profitability, this practice is not now acceptable in the proper determination of income.

4. The present system permits a deduction in respect of the cost of facilities under construction but not yet in use. Accordingly, considerable allowances may be claimed where no depreciation would normally be booked.

In addition, a full year's allowance may be claimed in the year of acquisition regardless of when the property is acquired during the taxation year (e.g., it may only be acquired in the last month of the taxation year).

5. There is no foundation in accounting or financial practice for the accelerated depreciation which is allowed for tax purposes, as described in Chapter 2 under the heading of "Economic Incentives". These additional allowances are primarily attempts by the government to influence the national economy.

It is interesting to note that, with the exception of the practice of retaining losses on disposal in undepreciated capital costs, the departures from generally accepted accounting principles allow a taxpayer to claim more capital cost allowances than he would normally book as depreciation, and thus pay less tax.

EQUITY

The grouping of assets may be inequitable if a taxpayer has assets falling within a particular class, and all of these assets have useful life expectancies shorter than the average set for the class. In this situation the taxpayer is at a disadvantage in relation to other taxpayers who have assets with longer life expectancies in the same class or with a cross-section of assets in the same class.

This may be particularly true of classes of assets on which allowances are calculated at 20% of the reducing balance. All tangible assets which are not specifically included in another class are included in Class 8 and, as a result, assets with widely varying useful life expectancies fall therein. Because of this, the composition of this class for one taxpayer may differ substantially from that of the same class of another taxpayer.

The inequity which arises between taxpayers because of the difference in the composition of their depreciable property would only be completely removed by reverting to a system based on depreciation of individual assets, or by recognizing profits and losses on the disposal of property under the present system. It would appear that the government has tried to reduce the seriousness of this inequity which arises from the grouping of assets by providing for relatively generous rates of capital cost allowances for

each class in order to ensure that taxpayers receive an adequate allowance on all depreciable property. At present the rates of capital cost allowances are considered adequate, with the following exceptions which were brought to the Commission's attention in briefs submitted by taxpayers:

(a) The maximum allowance on heavy construction equipment is 30% calculated on the reducing balance (Class 10). This permits a write-off of 65.7% of the cost of the equipment over a three-year period. It has been suggested by several taxpayers making submissions to the Commission that this rate is inadequate because such equipment is required to work under very adverse conditions which literally demolish it over a short period of time. In addition, advancements in design and power of new equipment have resulted in a high obsolescence factor for this type of equipment. It was recommended, therefore, that a rate of 40% be allowed on contractors' mobile equipment which would allow a write-off of 78.4% in the first three years. In fact, the Regulations were amended in 1964 to create Class 22 which provides an allowance of 50% on such assets acquired after March 16, 1964; this permits a write-off of 87.75% in the first three years.

(b) Electronic data processing equipment and punch-card equipment fall within Class 8 and are subject to a 20% capital cost allowance rate. It has been suggested that this rate is inadequate for this type of equipment because of the high obsolescence factors related to it. The taxpayer making this submission to the Commission gave evidence that 94% of its own Class 8 additions was represented by data processing equipment which, because of technological change, was subject to rapid obsolescence, and the equipment proved to have an average service life of only 3.83 years. To correct this situation the taxpayer suggested that either a new

classification and rate structure for data processing machines and electronic data processing machines be established, or some provision be made for the deduction of losses on disposal of assets in a class.

(c) Machinery and equipment which are an integral part of a building (e.g., elevators, sprinkler systems, wiring, etc.) are considered to be part of the building and, therefore, are included in a class with the building and depreciated at a rate of 5% or 10%, depending upon whether the building is of a solid or frame construction. Similar equipment not considered part of a building is included in a class which is depreciated at a rate of 20%. It has been suggested by several taxpayers that services within a building should be included in the 20% class as well. The increase in the importance of equipment in the cost of buildings recently is also cited as a reason for requiring a 20% class. The building, along with any integral parts thereof, is considered to be a group of assets making up a prescribed class. The present capital cost allowance rate ascribed to the class is based on the average life of all of the components of the building and would appear to be generous enough to cover the combined lives of these component parts. One of the taxpayers concerned with this particular matter admitted that he considered the depreciation rate for buildings to be liberal.

The grouping of assets is largely a practical matter which provides simplicity of administration. This is particularly the case when dealing with integral parts of a building. Although it may be possible to assign costs to the components of a building when it is new, it would be another matter to break down the purchase price of the same building on subsequent transfers between taxpayers. The administration is having difficulty

enough in applying the provisions of section 20(6)(g) when allocating the purchase price of depreciable and non-depreciable property.

REFERENCES

- 1/ Hereinafter referred to as C.I.C.A.
- 2/ B.C. Power v. Atty. Gen. of B.C., 44 W.W.R. (1963), pp. 230-236.
- 3/ This appears to be a logical assumption to make since the taxpayer is in the best position to judge the estimated useful life of the asset and the appropriate method of depreciation.
- 4/ The present value of the total tax savings and additional taxes.
- 5/ Canadian Tax Reporter, CCH Canadian Limited, para. 11-003.
- 6/ A. H. Hamilton, "Section 1100(4), The Effects of Its Removal", Canadian Tax Journal, July-August 1954.
- 7/ Ibid.

CHAPTER 4—ALTERNATIVES

METHOD OF CALCULATING DEPRECIATION

In establishing a depreciation policy for tax purposes, the government has two basic alternatives it may choose from. It may:

1. allow the taxpayer to choose the method of calculating depreciation and either
 - a) require that the method be reasonable and regulate the rates of depreciation allowed under the method chosen;
 - b) allow the taxpayer to determine the rates of depreciation but restrict the deductions allowed to the amount recorded on his books; or
 - c) allow the taxpayer to determine the rates of depreciation without restriction;
2. specify a method of depreciation and the rates to be used (such as the reducing balance method required at present).

The methods of depreciation which are most commonly used and which would, therefore, likely be the most reasonable to consider under items 1 and 2 above are as follows:

Reducing Balance

The reducing balance method, sometimes called the fixed percentage of declining balance method, provides for depreciation to be calculated based on a constant percentage of the depreciated book value of an asset or group

of assets. That is, the annual depreciation charge is a constant percentage of the difference between the amount of the asset account and the amount of the previously accumulated allowance for depreciation. (These last two accounts have been netted to form what is termed "undepreciated capital cost" under our present system.) The result is that the amount of depreciation taken in the earlier years of the life of an asset is greater than the amount taken in later years because the base upon which the depreciation is calculated gradually reduces.

The declining balance method is considered to most closely reflect the normal conditions of depreciation by some experts in the fields of accounting, engineering and economics. According to one American writer, "Assets actually lose value in a manner that is best reported by the declining balance method.... The method allows an equitable and realistic allocation of depreciation to each period during the asset's life, and it results in book values of assets which can be related to market values". 1/

In the present Income Tax Regulations, the reducing balance method of depreciation has been adopted as the method to be used in all but a few instances by all taxpayers except farmers and fishermen. The main features of the capital cost allowance system have been outlined in Chapter 2.

Straight Line

Straight-line depreciation was generally used for financial accounting purposes and for tax purposes during the first thirty-two years of income tax legislation in Canada. In 1949, with the introduction of the capital cost allowance system, and the requirement that capital cost allowances claimed for tax purposes be recorded on the books of the business, many

taxpayers increased the provision for depreciation in their accounts in order to claim the additional amount allowed under the declining balance method, thereby reducing their tax liability. With the repeal of the booking requirement in 1954, it was no longer necessary for taxpayers to book this additional amount and many taxpayers merely booked the amount calculated by the straight-line method of depreciation. The straight-line method is widely used in business in Canada today.

The straight-line method of amortization assumes that depreciation is a uniform function of time—that the depreciation occurring in one hour or day of the life of a property is identical in amount with that occurring in every other hour or day, assuming no change in basis in the meantime. Under this method the amount of depreciation for an accounting period or other unit of time is obtained by dividing the amount to be depreciated by the number of periods.

The popularity and general use of the straight-line method of depreciation by industry in Canada and in the United States is primarily due to the fact that it provides for the uniform distribution of the cost of an asset over the years of its anticipated useful life, and it is relatively simple to calculate annual depreciation charges. In supporting the use of straight-line depreciation, Paton and Littleton had this to say:

Since units of plant are conceived as bundles of services, the best procedure would be to apportion their cost wherever possible in terms of the stream of services rendered. In other words, some form of production or output method would be the most appropriate base. Thus airplane motors could be depreciated on the basis of flying hours, motor cars on the basis of miles operated, pumping equipment on the basis of gallons delivered, and so on. The difficulty in the way of a general adoption of this approach is that of making a reasonably dependable estimate of the number of units of service to be rendered during the probable life of the particular element of plant. Besides,

physical deterioration is not always proportionate to intensity of use and there is evidence that the effect of such factors as obsolescence—is not related to the fluctuations in output. For most situations straight line calculation of depreciation is an acceptable and even a preferred form of the production standards. Adoption of the straight line procedure, it should be added, does not prevent spreading the annual charge, in interim computation, in proportion to seasonal variations in output.

The straight line method of apportionment, with its uniform yearly charges, is subject to the objection that it ignores the relation of rate of return and remaining investment. The compound interest method of apportionment (in its various forms) is designed to cure this theoretical limitation of straight line reckoning. In this connection, it is sufficient for the purposes of this discussion to point out that for the typical industrial concern, with its numerous classes of plant units of varying lives, it seems clear that the compound interest method of apportionment is unduly complex and cannot be expected to yield as reasonable results as the straight line treatment. 2/

Sum of the Digits

This method is similar to the declining balance method, in that larger amounts are written off in the earlier years of an asset's life and smaller amounts in the later years of life. It is based on the sum of the digits corresponding to the estimated average life. For example, assuming an estimated life of 20 years, the digits from 1 to 20 when added together give a total of 210. The depreciation charge in the first year is then $20/210$ of the difference between the first cost and the estimated salvage value; the charge in the second year is $19/210$; in the third, $18/210$; and so on, until the twentieth year when the charge is $1/210$.

The curve of book value by this method may be defended as reasonable under many circumstances. However, the difficulties of applying a different rate to each year's acquisitions to determine the depreciation charge in a year, tend to limit its use. And secondly, the sum-of-the digits method is rarely used in Canada in contrast with the declining balance method and the straight-line method.

Production Methods

The production or output method of calculating depreciation is considered by many authorities as the best method of apportioning costs (e.g., Paton & Littleton). An example of the production method is that based on the units of production.

Under the units of production method, the company engineers compute an estimate of the number of pieces which a machine should produce during its useful life. The cost of the machine is divided by the number of units to arrive at a depreciation cost per unit, and this cost is multiplied by the actual number of units produced during the period. $\frac{3}{/}$

A similar method is based on the expected hours that a machine will run, and the unit rate is arrived at by dividing the cost of the machine by the total expected hours of use.

The statistical information required for this method is not usually readily available, and, therefore, the method has limited application. The records required to apply the method are also a factor limiting its use.

Sinking Fund Method

The sinking fund method attempts to do a little more than the previously described methods of depreciation and is, therefore, not truly comparable with those methods. This method recognizes interest as a factor in the cost of the utilization of any fixed asset. The periodic cost of operating the asset is the full amount of the discounted periodic service plus interest earned on the remaining value of the investment in the asset. The method requires the additional feature of the systematic accumulation of a fund which will amount to the expired value of the asset at the end of its service life.

The practical value of the sinking fund method is limited by the variety and complexity of depreciable property found in many enterprises and by the difficulty in estimating earning power. As a result, it is not commonly used in business. The method is most commonly used by municipalities to recover the cost (including interest) of long-lived capital projects from ratepayers in the form of property taxes.

Evaluation

Each of the foregoing methods of depreciation used in business practice has its advantages and disadvantages depending upon the circumstances under which the method is applied.

Taxpayers Allowed a Choice of Methods

Method to be Reasonable and Rates Regulated. Tax legislation followed this general approach in Canada from 1917 to 1949. Although the straight-line method was most popularly in use, any other methods which were reasonable could be used. The rates applicable to the method in use were regulated by the Department of National Revenue but were not published for the benefit of taxpayers.

A similar approach is used in the United States at present. The straight-line, declining balance and the sum-of-the digits methods are specifically authorized by the Internal Revenue Code of 1954. In addition, "any other consistent method" is authorized. The rate of depreciation for each asset is established as a question of fact. However, the Revenue uses a bulletin, published by itself which contains a list of assets, each with a recommended useful life, as a guide in determining the proper rates of depreciation. This approach to tax depreciation provides a more

accurate measure of depreciation than our present system by allowing consideration of factors relating to each item of depreciable property. The basic disadvantages of such an approach are the administrative complexity which arises in dealing with each item of property and the uncertainty of the law which results when rates of depreciation are negotiable and confidential to each taxpayer.

Depreciation Restricted to Amount Booked. The basis for a system of tax depreciation which allows the taxpayer to deduct what has been recorded on his books of account assumes that the taxpayer is in the best position to determine what his depreciation charge for the year should be, and that this amount should be allowed as a deduction in arriving at income subject to tax.

For the period from 1938 to 1951, Sweden adopted this approach to depreciation for tax purposes. Corporations and "economic associations" were allowed to claim capital cost in any amount, provided the same amount was recorded on the books. Recapture was provided for, in that all proceeds on the sale of fixed assets were treated as gross income and were subject to tax. The system was discontinued in 1951 because "in any inflationary period unrestricted depreciation appeared to be adding fuel to the fire and, what was equally serious, the retention of large reserves of untaxed profits insulated corporations from the effect of fiscal and monetary control measures". ^{4/} In addition, in order to benefit from the tax regulations, there was a movement away from sound accounting practice in the treatment of depreciation on the books.

Some of the advantages and disadvantages of this approach are outlined below.

Advantages:

- (i) The system would be simple to administer.
- (ii) The system would recognize generally accepted accounting principles as the criteria for establishing deductions for depreciation for tax purposes.
- (iii) Compared to the present system which is relatively rigid in its application, the proposed system would allow the recognition of special conditions peculiar to each taxpayer.

Disadvantages:

- (i) As in the Swedish experiment with such a system, taxpayers would be tempted to set their depreciation rates more from a tax point of view than from the point of view of good accounting practice. In order to control the tendency to overstate depreciation under such a system, it has been suggested that the audited financial statements be accepted as the basis for establishing net income. This implies that the Taxation Division of the Department of National Revenue would rely on the auditors to assure that net income, including depreciation, is determined in accordance with generally accepted accounting principles.

In a draft of the present Income Tax Act, it was proposed that income for tax purposes should be determined by using generally accepted accounting principles. This provision was removed after it received considerable criticism from organizations of professional accountants which did not consider accounting principles sufficiently defined for such a purpose. Whether such principles are sufficiently defined at this time is uncertain.

Preliminary indications are that there is not yet enough agreement among professional accountants as to what constitutes generally accepted accounting principles for the Department of National Revenue to rely exclusively on published financial statements to establish income subject to tax.

In addition to the problems of establishing uniformly acceptable accounting principles, not all businesses are required to have their financial statements reported on by independent auditors. The Dominion Companies Act requires all companies to have an audit, but only in the case of public companies must the audit be carried out by someone considered to be independent. There is no legal requirement for non-corporate businesses to have their books of account audited. To require all non-corporate businesses and private corporations to have their statements audited (presumably by someone considered to be independent) would involve them in additional expenses which they might not consider justified.

- (ii) In many cases, capital cost allowances have exceeded the actual depreciation booked by businesses. This additional deduction may have acted as an incentive to businesses to modernize existing plant and equipment and to expand. A system which recognizes book depreciation as the amount to be deducted for tax purposes, would remove this possible incentive. It should be noted, however, that businesses, in order to minimize the loss of this incentive, would probably adopt a method of depreciation such as the declining balance. In addition, the government, if

it were so desired, could provide incentives in other ways without disturbing the basic depreciation system. This is now being done in specialized areas (e.g., scientific research expenditures).

- (iii) Perhaps one of the most important drawbacks in such a system would be the possible reluctance of the accounting profession to assume the legal responsibilities which may be attached to their duties under the system. These responsibilities could require a change in the nature and extent of the audit work at present required to form an opinion on financial statements, to the point where auditors' services would become extremely expensive to clients.

Depreciation Without Restriction. To allow capital cost to be claimed by the taxpayer without restriction would result in an approach to capital expenditures for tax purposes similar to that of current expenditures except, of course, that the latter may not be deferred except in certain instances.

The effect of such a system on government revenues is difficult to assess because of the number of variables involved. However, it is likely that, in the earlier years at least, such a treatment would result in considerable loss of revenue to the government.

Some of the advantages and disadvantages of a system of unrestricted depreciation for tax purposes are outlined below.

Advantages:

- (i) The system would be simple to administer.

- (ii) Temporarily at least, investment in new plants and equipment might be stimulated.

Disadvantages:

- (i) The system could result in a material loss of revenue to the government (in the short term at least).
- (ii) The system could be inflationary.
- (iii) As in the Swedish experience, corporations may tend to become immune to fiscal and monetary control measures.
- (iv) Such a system completely ignores sound accounting practices and, therefore, the proper determination of income.

Although both alternatives above would provide much desired administrative simplicity and flexibility for taxpayers, it is unlikely that they would be acceptable in practice because of the seriousness of the objections outlined above.

**Taxpayer Restricted to Methods
and Rates Prescribed**

This is basically the approach adopted under our present capital cost allowance system. The method of depreciation to be used and the maximum rates applicable thereto are restricted to those provided under the Income Tax Regulations, and must be adhered to without variation. The maximum rates allowable are published and, therefore, there is a degree of certainty inherent in our present system. In addition, the reducing balance method, when applied to classes of assets, provides a relatively simple method of amortizing capital expenditures for tax purposes for both the taxpayer and the administration.

The United Kingdom adopts a similar approach to our own in that they allow only straight-line depreciation on industrial buildings at 2% and either straight-line or reducing balance allowances for machinery and equipment. There is a little more flexibility in their rate structure since taxpayers may appeal to the Commissioners the rates established by the Revenue.

BASES ON WHICH DEPRECIATION MAY BE CALCULATED

Historic Cost

The present capital cost allowance system is based on the amortization of historic cost; that is, only the actual cost of the depreciable property to the taxpayer is charged against earnings, regardless of when the taxpayer made the expenditure for the property and what it would currently cost to replace the property.

Although other bases have been considered, the use of historic cost as a base for depreciation is still recommended by organizations of professional accountants in the United States, England and Wales, and Scotland, as well as in this country.

The theory supporting the use of historic cost

...regards a business venture as of indefinite life, but not perpetual: treats its capital as consisting of sums of money invested at different times in varying kinds of assets: and treats a depreciation allowance as providing against the consumption of that money capital which takes place through the wasting of the fixed asset, in which it has clothed itself, in the service of the business. If the money capital thus consumed has been made good out of profits by the time the asset has ceased to be used in the business, profits have been properly computed. From this point of view it is irrelevant, for the purpose of computing profits, that the purchasing power of

money in terms of comparable fixed assets has declined over the period so that a similar fixed asset could not be purchased at the same price. The fall in the purchasing power of money is common to the trader and other taxpayers, and if he decides to continue in business with a new and more expensive asset he must venture that much more money and hope to recover from its use a correspondingly larger monetary return under the new conditions. 5/

Replacement Cost

Despite the general recognition of historic cost as the most appropriate depreciation base, there has been increasing criticism of its use during the last twenty years of creeping inflation. It has been strongly urged that the historic cost basis should be abandoned in favour of some alternative which reflects the current price level (i.e., replacement cost).

The replacement cost theory

...regards a trader's capital as consisting of the actual assets that belong to his business, the money capital having been expended once for all on their acquisition: treats those assets, insofar as they waste, as being themselves the capital that wastes in the course of earning profits: and treats a depreciation allowance as being a measure of the deterioration of the value of the asset concerned that has taken place during the period of account. According to this theory, a business is a continuous and permanent activity, and, when a wasting asset has been employed in it, the profits of the activity have not been correctly computed over the period of the employment unless they have been charged with so much as may turn out at the end of the life of the asset to be required to replace it as before. At any rate, it is said, the measure of wastage of a fixed asset in any one year ought to be in accordance with its value in that year and the current relation of money to prices.

An alternative approach to the [replacement cost] theory is to distinguish between [monetary units] of one year and [those] of another according to the difference in their internal purchasing power. What is said is that in a period when the value of money is diminishing, the [dollars] of today ought to be treated as different things from the [dollars] of yesterday, and the [dollars] of tomorrow as different from both. An income and expenditure account in which income receipts are expressed in [dollars] of today and some expenses in [dollars] of today and some expenses, such as depreciation in [dollars] of yesterday is misconceived since like is not being set against like. 6/

The following arguments for and against replacement cost flow from the basic differences between the theories supporting that basis and the historic cost basis.

Arguments for Replacement Cost

1. The proponents of the replacement cost basis argue that its use would result in a truer determination of profits. In the view of John E. Kane, depreciation should provide for the maintenance of capital. It should provide for this maintenance by stating depreciation in current dollars, and thereby limiting the distribution of funds to stockholders and to government and, possibly, by having an effect upon other disbursement decisions. 7/ It is not felt that depreciation based on historic cost will provide for this maintenance.

2. The second argument, which more or less flows from the first, is that the present system is injurious to the economy of the country and should be discontinued. This argument is based on the views that the capital of productive enterprises is being eroded and that in the future it is possible that industry will find it difficult to maintain an adequate level of investment in physical assets. (However, it is interesting to note that in the final report of the Royal Commission on the Taxation of Profits and Income in the United Kingdom, the Commission stated that there was no conclusive proof that over a specified period, industrial capital had been eroded by taxation.) 8/

Arguments Against Replacement Cost

1. The calculation of depreciation on a replacement cost basis would be less objective than when based on the present historic cost basis. Among

the proponents of replacement cost depreciation there is not only lack of agreement on what the desired objectives of a replacement cost depreciation system should be, but also considerable disagreement on how the objectives should be achieved in practice.

Basically, the differences lie between those who believe that the adjustment should reflect only the change in purchasing power of the monetary unit, and those who argue that the adjustment should reflect all price changes for specific assets. These latter would include unrealized profits and losses due to market fluctuation and technical changes, etc.

Depending upon which school of thought is followed, and the degree of accuracy required, depreciation charges based on original cost may be converted to current prices in one of several ways. It is usually done by the use of a formula (price index) or by revaluation of specific assets (on which depreciation is then calculated).

2. Besides replacement cost being difficult to determine, depreciation on this basis does not, in effect, guarantee that funds will be retained in the business sufficient in amount actually to provide for replacement of assets. In addition, replacement assets do not necessarily bear any resemblance to assets being replaced.

3. Financial statements are mainly used to report on the stewardship of management in handling the capital funds entrusted to its care. Legal capital is defined at present in terms of the amount of money actually contributed to the company, and not in terms of the real assets bought with such money. Therefore, in order to keep a clear distinction between capital which legally must be maintained and income which is legally distributable, it is necessary to keep the accounts so as to reflect the money costs

actually incurred by the company. The decision of a business not to pay out all of its income so defined is a financial decision and not one which necessarily requires the revision of established methods of income determination.

4. Those who use financial statements generally understand the present accounting conventions and their limitations and are able to use them with confidence. Changes in accepted accounting methods would introduce confusion and generally make accounting statements less useful. In addition, many legal or quasi-legal rights and obligations now defined in accounting terms might be affected by changes in accounting practice. This may be confusing at the least, and possibly inequitable.

5. From the point of view of administration, replacement cost accounting would involve considerable extra clerical work both on the part of the Department of National Revenue and the taxpayer because assets would have to be adjusted yearly. The use of appropriate index numbers, if available, would reduce this problem but would not eliminate it.

6. To allow depreciation on a replacement cost basis would tend to be discriminatory unless the tax system was revised to take into consideration the decline in purchasing value of the dollar as it affects all classes of taxpayers. In the words of the Tucker Committee which studies the problem in the United Kingdom:

Whether the proposed schemes were based upon revalorization or upon the creation of a reserve for replacement, in essence the whole amount to a proposal that a business should be relieved altogether from tax from some part of its true profits, that is to say, upon its profits as computed on ordinary accounting principles. In fact this relief from tax would not apply to all businesses but only to those which require to replace fixed assets or stocks. To that extent therefore the treatment asked for would be of preferential nature. 9/

Under the present system, in a period of rising prices owners of depreciable assets gain financially, relative to owners of financial assets. Depreciable asset owners realize some revaluation gains even after paying a tax on them: the financial asset owners realize none. Thus, depreciable asset owners are less badly off in real terms after paying taxes than are financial asset owners. Depreciation adjustment would increase the spread between these two types of assets by exempting revaluation gains from tax. Price inflation would then permit depreciable asset owners to hold their own in real terms, while financial asset owners would continue to bear the full brunt of inflation. 10/

According to E. Cary Brown, to be equitable from a theoretical point of view, income taxes should be imposed only on changes in real net worth. 10/ If applied in practice, this would mean exempting revaluation gains because they would not change a taxpayer's real net worth, and reducing taxable income by losses in purchasing power suffered by those owning financial assets.

This result would be achieved by readjusting all assets and liabilities for price changes, not only depreciable assets. This procedure would recognize in tax policy the difference between owners of financial assets and owners of depreciable assets. The same result is now achieved under our present system where changes in the money value of net worth and historic cost depreciation are used for tax purposes. Under this system, revaluation gains that accrue to depreciable asset owners are taxed (since they represent increases in money net worth), whereas financial asset owners report no such gains as taxable income. 10/

7. Replacement cost depreciation tends to confer a benefit upon existing firms since they have tax-free funds for replacement in a period of rising prices, whereas new firms must procure these additional funds in some other way.

8. From the point of view of its effects on the economy,

In general, replacement cost depreciation for tax purposes appears to be mildly destabilizing. It would reduce the stabilizing effects of tax collections by reducing boom receipts and increasing the depression receipts. Firms would pay less taxes in a boom and have more cash to buy machinery and equipment and inventories or to pay in dividends. The increased demands for goods and services would increase inflationary pressures. On the other hand, replacement-cost depreciation when used in corporate reports, would reduce fluctuations in profits after taxes, and perhaps reduce fluctuations in business expectations and investments. There is no decisive way of casting up the balance between these two phenomena, but the first appears to be the more important. 11/

The more certain steps toward reducing economic fluctuations through depreciation changes would be to require the continuance of historic cost depreciation for tax purposes and to encourage the switch to replacement cost depreciation for book purposes. The stabilizing effect of the present method of tax collection would be continued and, further stabilization could be achieved through the reduction in the fluctuations of business profits as shown in present financial reports. 12/

The long-run effects of replacement cost depreciation depend largely on future prospects. If long-run inflationary prospects are the most likely, replacement cost depreciation for tax purposes would probably increase the fraction of national income going into capital formation. Whether replacement cost depreciation is the best way of achieving this end is questionable, since the tax benefit tends to spread itself over the whole industrial landscape without reference to the special needs for certain kinds of capacity. 12/

Although the arguments against replacement cost depreciation are numerous, professional accountants in both the United States and in England, while recommending the temporary continuation of depreciation based on historic cost, recognize that the traditional methods of reporting income are inadequate and that some way should be found to correct this situation. The Council of the Institute of Chartered Accountants in England and Wales recommends to members who are directors or officers of companies or who are asked by clients for some advice:

...that they should stress the limitations of the significance of profits computed on the basis of historical costs in periods of material changes in the purchasing power of money; and that they should draw attention to the desirability of: a) setting amounts aside from profits to reserves in recognition of the effects which changes in the purchasing power of money have had upon the affairs of the business, particularly their effect on the amount of profit which, as a matter of policy, can presently be regarded as available for distribution; b) showing in the Directors' reports or otherwise the effects which changes in the purchasing power of money have had on the affairs of the business, including in particular the financial requirements for its maintenance and the Directors' policy for meeting those requirements, either by setting aside a reserve or by raising new capital; c) experimenting with methods of measuring the effects of changes in the purchasing power of money on profits and on financial requirements. 13/

The American Accounting Association, in a bulletin issued in October 1951, expressed the view that the time has come to give adjusted dollar statements a thorough test. Such statements should now be and may continue to be supplementary to financial statements based on historic dollar costs. 14/

Businessmen in the United States would appear to agree with these professional bodies on the shortcomings of historic cost. In a survey of approximately 670 corporate executives and educators in July 1957, approximately 75% of those replying were in favour of reflecting current dollar cost of depreciation in some appropriate manner in corporate reports

to shareholders. These businessmen indicated that they felt that unless operating expenses reflect current dollar cost of depreciation, they would be understated; as a result, net income would be overstated, income taxes would be inequitably high in many cases and often would partly be paid out of capital, and a main part of dividends paid would represent a return of capital rather than a distribution of earnings. 15/

Although replacement cost depreciation appears to be generally accepted in theory, and its use may be desirable for book purposes, it would be inequitable and impracticable at present for tax purposes for the reasons stated above.

Cost to Original Owner

Depreciation as a financial concept has traditionally been based upon the original cost of the asset to the owner. Although there are those who argue in favour of a basis other than original cost (i.e., replacement cost), the cost basis is generally accepted on the grounds that it is conservative, objective and easily verified.

For tax purposes, however, the determination of capital cost allowances on the basis of original cost to the taxpayer may create undesired anomalies.

The present system allows capital cost allowances on the cost of the depreciable property to the taxpayer. The base on which capital cost allowances are claimed may be increased by the sale of depreciable assets between taxpayers. Theoretically, the purchasing taxpayer would be willing to pay more for an asset when he is allowed to claim capital cost allowances

on the cost of that asset to him than he would be willing to pay if he were only allowed to claim allowances based on the cost of the asset to the original owners (i.e., the vendor).

Theoretically, the present basis for depreciation will tend to increase the number of transactions of depreciable property (particularly buildings) between taxpayers because it provides a taxpayer with a means of increasing the base upon which capital cost may be claimed by merely switching assets. Thus, if a taxpayer owns a building which has increased in value, it would be to his advantage to sell that building and buy a comparable one at approximately the same price. If that price is above the cost of his original building, the taxpayer has effectively increased his capital cost upon which allowances may be claimed while maintaining the substance of his investment.

Although section 20(1), which provides for recapture of depreciation in certain instances, should limit such switching of assets, it is possible to avoid its provisions under certain circumstances. Where a taxpayer sells a group of assets, it may be possible for him artificially to apply the proceeds of sale to the classes of assets in such a way as to create little or no recapture and maximum capital gains. It is understood that this has been done successfully in several instances (e.g., in British Columbia on the sale of a lumber mill and timber limits), despite the provisions of section 20(6)(g) which might apply.

In addition to subsidizing a portion of the purchase price on sales of depreciable assets between taxpayers, the use of cost to the taxpayer as a basis for depreciation may lead to speculation in such transactions, thus diverting economic effort away from productive enterprise.

Although the weaknesses of the present system described above are theoretical possibilities, it would require the right combination of circumstances for a taxpayer to take advantage of them. For example, a taxpayer would only be willing to switch assets if a comparable asset with a comparable return were available, and if he were not to suffer too much recapture of depreciation. If recapture of depreciation is a problem the taxpayer must have other non-depreciable property he is willing to sell which will allow him to manoeuvre the proceeds of disposal. In addition, the purchaser must agree with the vendor on the application of proceeds of sale to the assets sold. It would appear unlikely that all of these circumstances would exist together, and the problem, therefore, appears to be a theoretical one but not a practical one.

Although this weakness in the system would not likely give rise to many transactions designed to exploit the weakness, once sales are negotiated for other reasons, the tax feature referred to above could play a part in resolving the final terms of a contract. Thus, on the sale of depreciable and non-depreciable property, the terms of sale could be arranged in such a way that the vendor suffers little recapture and maximum capital gains. This possibility points up the need for a provision such as section 20(6)(g) of the Act.

Depreciation based only on cost to the original owner would be foreign to most taxpayers and their accounting advisers. It would depart drastically from the currently accepted financial concept of depreciation based on cost to the owner.

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CHAPTER 5--SECONDARY ANOMALIES, INEQUITIES AND LOOPHOLES
ARISING FROM THE CAPITAL COST ALLOWANCE SYSTEM

LEASE OPTIONS

The Problem

When a taxpayer acquires a capital asset he is not permitted to deduct any amount from his income in respect of the purchase price of the asset acquired except to the extent of the allowance provided under the capital cost allowance system. This allowance is calculated as provided in the Regulations, and depends upon the cost of the property to the taxpayer and its estimated useful life as reflected by the "class" into which it falls. This is the case where the taxpayer acquires immediate title to the property.

However, in order to use or enjoy possession of property it is not necessary for the taxpayer to acquire immediate title thereto. The leasing of real property and, latterly, the hiring of depreciable property are common business practices. Bona fide rental payments have always been recognized as legitimate business expenses for purposes of the Income Tax Act (i.e., deductible as a current expense). This is implicit in section 4 of the Act which purports to define income from business or property.

...income for a taxation year from a business or property is the profit therefrom for the year. 1/ [Emphasis added.]

A problem arises when a taxpayer seeks to purchase property and to disguise the transaction as a lease, thereby claiming the cost of the property as a deduction over a shorter period than is provided by the

Regulations dealing with depreciable property, and/or claiming the cost of property not otherwise deductible.

For example, if he desires to buy a building and the land upon which it stands for \$100,000, rather than make an outright purchase, he may cloak the transaction under a "lease" or a "lease option". Under this arrangement he will pay, shall we say, \$10,000 a year "rent" for ten years, exercise his option at the end of that period, and make a terminal payment which represents the accumulated interests and carrying charges. Having exercised his option, he now has acquired title to the property. If such a transaction is permitted by the taxing authorities, the taxpayer not only succeeds in writing off the capital cost of the building in ten years, but he also obtains a deduction for the value of the land which is not otherwise deductible.

This is a simple illustration of the problem and in this form is easily recognized for what it is—a device used by the taxpayer to circumvent the Regulations on capital cost allowances. However, in practice, leasing arrangements take many forms and it is often difficult to distinguish those used to avoid tax from those which are genuine business arrangements in which the taxpayer protects his essential business interests by leasing property with an option to purchase or renew.

Section 18

Section 18 was enacted to stop taxpayers from circumventing the Regulations on capital cost allowance by deducting an appreciable portion of the purchase price of property in the form of rent and from obtaining a deduction for non-depreciable property. Its purpose was to even out the position of taxpayers purchasing property through lease option agreements

or similar arrangements with the position of taxpayers acquiring immediate title to depreciable property through straight purchase arrangements. The section turned out to be an anathema to the Crown because of the following:

1. It gave rise to schemes whereby the taxpayers claimed capital cost allowances greatly in excess of rents actually paid. An example of such a scheme is illustrated in the case of L. J. Harris. 2/

A gasoline station was bought by a company for \$31,000, and was leased to an oil company for 25 years at an annual rental of \$3,900. A concurrent lease was granted to the taxpayer for 200 years at an annual rental of \$3,100.08, on condition that the latter deposit \$10,000 with the company as security for the performance of all covenants, and repayable at the expiration of the 200 year lease. The lease also contained an option for the taxpayer to purchase the property for \$19,500, at the expiration of the 200 year term. The taxpayer claimed capital cost allowances of \$30,425.80 for 1960 in connection with his lease option based on an annual rental for 200 years.

By this transaction, the taxpayer hoped to claim large amounts of capital cost, thereby reducing his income tax for the 1960 taxation year by \$13,278.11. The capital cost allowance claimed in 1960 represented approximately 200% of the estimated value of the depreciable building at that time.

The Tax Appeal Board ruled against the taxpayer, holding that the option in the agreement was void, as it was an infringement of the Rule Against Perpetuities. In addition, they suggested that the whole arrangement was artificial and fictitious in its nature and not related to the true depreciation of the building, the deduction claimed, therefore, being

barred by section 137(1); since the option was personal to the taxpayer and did not enure to the benefit of his heirs, executors, administrators or assigns, it followed that he was the only person who could exercise it and there was, of course, no possibility that he could do so; and that the calculation of capital cost under section 18 does not include rents payable, but only those rents that have been paid.

It should be noted that on appeal to the Exchequer Court that Court dismissed the appeal on the grounds that section 18 (prior to its repeal) allowed capital cost allowance on the capital cost equal to "the price fixed by the contract or arrangement", which, in the Court's view, was the consideration payable at the time the option is exercised.

2. Although it appears that the section operated successfully to block purchase agreements disguised as lease-option agreements wherein the lessee had a right to purchase, its provisions were easily avoided by taxpayers through the use of renewable options and/or rejectable offer clauses in the leasing agreement.

Taxpayers were able to escape the provisions of section 18 and at the same time assure themselves of unlimited rights of use or occupancy by having options to renew the lease, rather than options to purchase. The rent under any renewal would be nominal since all the lessor's investment would likely be recovered during the initial term of the lease which would be substantially shorter than the estimated useful economic life of the property. By paying for the cost of the property to the lessor during the first term of the lease, and deducting such payments as rent, the taxpayer was able to avoid the restrictions of the capital cost allowance system (including the prohibition against deducting the cost of non-depreciable

property). In the event that it would be advantageous to the lessee to own the property after the initial term of the lease, the present value of future rents would be such that a payment of a small percentage of the original value of the property would be sufficient to purchase the property and compensate the lessor for the loss of rents. 3/

Another means by which the taxpayer was able to circumvent the provisions of section 18 was through the use of a rejectable offer clause in the lease agreement. Such a clause does not give the lessee a right to purchase the property for a specified amount, but merely gives him the right to offer to purchase the property at a specified price. Although such an offer may be rejected by the lessor at his discretion, in practice, it was usually accepted because of a prior understanding between the two parties. The lessee may protect itself against the eventuality of the rejection by including in the lease agreement, options to renew the lease at nominal rental.

3. Section 18 created an artificial situation which operated to the advantage of taxpayers who wished to use lease-option and hire-purchase arrangements as bona fide means of financing. Although subsection (4) of section 18, which was introduced in 1957, was meant to provide a degree of relief to these taxpayers by exempting lease options where the amount fixed by the contract as the price at which the property may be purchased was not less than stipulated percentages of the market value of the property at the time the taxpayer entered into the contract, the percentages set by the subsection were too high to afford much relief. This was a fairly serious defect in the section since, from an examination of articles in the leading periodicals on the subject of leasing from 1960 to 1963, it would appear

that the multitude of arrangements being entered into in Canada today are primarily an alternative form of debt financing.

The repeal of section 18 in 1963 by section 4(1) of Chapter 21, 1963, eliminated the problem of tax avoidance described in (1) above, but it would appear that substitute legislation is required to cover the original problem, that is, the use of leasing arrangements to circumvent the provisions of the capital cost allowance system.

In attempting to formulate effective legislation to replace section 18, the following features should be considered:

1. Theoretically at least, the tax treatment of leased property in the hands of the lessor should have a bearing upon the tax treatment of the lessee. Basically, the lessor may treat his leased property in one of two ways for tax purposes—as capital assets or as inventory.

- (a) If the lessor is considered to be leasing a capital asset for tax purposes, he is only entitled to deduct capital cost allowances plus a terminal loss on disposal (i.e., when the lessee acquires title) if the property is the only one of its class. Any loss of non-depreciable property disposed of, for example, land, will be a capital loss and not deductible. Rents received by such a lessor will be treated as income when received, whereas the terminal payment will be considered as proceeds of sale. (Section 20(6)(g) will apply to apportion proceeds between depreciable and non-depreciable property).

It is unlikely that a lessee would find any tax advantage in acquiring property through a leasing arrangement from a lessor in such a position. Any savings the lessee might achieve by deferring tax by paying

high rents for a few years and a nominal terminal payment on the acquisition of the property would be lost because the lessor would tend to pass on his tax disadvantage arising from the transaction (i.e., slower write-off of capital costs and non-deductibility of any loss on non-depreciable assets) to the lessee in the form of higher rental payments. Under these circumstances, the government need not be concerned about a loss of revenue since the tax treatment of the lessor would operate as a deterrent to leasing arrangements whereby the lessee obtains a tax advantage, including the situation where a taxpayer obtains indefinite use of property through a leasing arrangement which provides for renewal of the lease on favourable terms at the option of the lessee.

(b) In contrast to the lessor who must consider the leased property as capital, the lessor who may treat the property as inventory may write it down annually to the lower of cost or market, and write off any remaining costs as a cost of sale when title to the property passes to the lessee. Such taxpayers are in an ideal position to offer tax advantages to purchasers by disposing of their property by means of leasing arrangements whereby the lessee is able to deduct a major portion of the cost of the property (both depreciable and non-depreciable) through high rental payments and nominal terminal purchase price. Any small interest costs the lessor may incur by not claiming an immediate write-off of the cost of the property could be passed on to the lessee in the purchase price without seriously affecting the attractiveness of a transaction to the lessee.

Ideally, legislation should be aimed only at those taxpayers in the latter circumstances.

2. Although he may enjoy all of the benefits of ownership, it is not necessary for a lessee to have title to the property nor to have any right to acquire title. Because of this, it is necessary for any new legislation, to be completely effective, to allow the administration and the courts to look beyond the form of the contract to its substance. Only in this way will the Department of National Revenue have the means to block tax avoidance schemes through the use of leasing arrangements.

3. Any proposed legislation which attempts to treat leasing arrangements as sale arrangements for tax purposes (in the manner of section 18), will have to provide a method of determining a reasonable capital cost of property acquired through such arrangements. Such a method should be designed so as to avoid the problems associated with the previous section.

4. Because a great many leasing arrangements are bona fide business transactions, any tax legislation which is aimed at them should provide for an exemption from its provisions for those business transactions which are genuine.

Alternatives

1. The Department of National Revenue appears to have accepted the recommendations of the Joint Committee representing the Canadian Bar Association and the Canadian Institute of Chartered Accountants that the objectives of the previous section 18 can be achieved through the application of the general provisions of section 12(1)(b) and section 12(2). Section 12(1)(b) disallows payments made on account of capital except as allowed through the Regulations on capital cost allowance, and section 12(2) disallows outlays which are unreasonable. Since, in order that it be a useful means of avoiding tax, a leasing

arrangement must call for the acquisition of the property through rental payments over a shorter period than the estimated useful life of the property, the amount of rent paid would likely be in excess of what a prudent businessman would pay for straight rental. The Department hopes to be able to disallow this excess as an unreasonable expense through the application of section 12(2) of the Act. In addition, it is suggested that the Department can disallow rental payments on lease options as being on account of capital and can allow only the appropriate capital cost allowances thereon.

Analysis

(a) The use of the general provisions, if effective, would allow the Minister to attack only those transactions which are for the purposes of avoiding tax. Bona fide business arrangements and transactions wherein the advantage to the lessee is offset by the tax advantage to the lessor would escape adverse tax consequences.

(b) The operation of section 12(2) to disallow the unreasonable portion of rentals may be effective in all cases except where land is involved or where the tax avoidance is marginal. Where a taxpayer claims substantial portions of the purchase price of property in rent, it may be possible to prove that the amount so claimed is in excess of what a prudent businessman would pay and disallow the excess accordingly. Any such disallowed portion of the rental payments would not be deductible even through capital cost allowances and the risk of losing a portion of the purchase price as a deduction would tend to act as a deterrent to the use of artificial transactions to purchase depreciable property. Since the cost of

non-depreciable property is not deductible at present, however, it would still be worth while for the taxpayer to acquire such property through a lease arrangement even though a portion of the rental paid therefor was disallowed for tax purposes.

It would appear, therefore, that although section 12(2) would be effective in the case of depreciable property, it would not entirely stop the deduction of the cost of non-depreciable property in the form of rent.

It may be that the Department is looking to section 12(1)(b) to stop the deduction of the cost of depreciable property through rental payments by adopting the view that such payments are on account of capital and, therefore, not allowable under that section. It is impossible to forecast accurately how the Courts would interpret the section as it may apply to such a case, except to say that in the past they have been more concerned with the form of the contract than the substance. This would lead one to believe that the present tax provisions for determining income would not be effective in blocking tax avoidance schemes through the use of these option arrangements.

(c) Even if payments under lease arrangements could be brought under the limitations of section 12(1)(b) and, therefore, under section 11(1)(a), and the Regulations, the present legislation does not provide a method of determining the capital cost of property acquired through such arrangements.

Conclusion. The present tax provisions for determining income will not be

adequate for purposes of controlling tax avoidance schemes through the use of leasing arrangements.

2. As an alternative to the recommendations adopted by the Department of National Revenue, the Joint Committee suggested that the provisions of the previous section 18 be retained with the following changes and conditions:

(a) the amount allowed as a deduction in a taxation year shall be the lesser of:

(i) the amount allowable for the class as provided by the Regulations, or

(ii) the amount by which the aggregate of the payments made under the contract in the taxation years exceeds the aggregates of the amounts allowed as deductions from income in previous taxation years by way of capital cost allowance or otherwise.

(b) The legislation shall not apply where the terminal purchase price is not less than what would have been the undepreciated capital cost of the property to the lessee at the time the option may be exercised, if he had acquired the property as depreciable property at fair market value at the time of the lease agreement and had owned the property to the date on which the option may be exercised as if it had been the only property of that class, and had claimed in each of the intervening taxation years the maximum capital cost allowance permitted under the Regulations prevailing for the taxation year in which the lease was entered into. 4/

Analysis

(a) The provisions of (former) section 18, along with the proposed changes, would still only apply to those arrangements whereby the lessee had a firm option to purchase the property for a specified time. Taxpayers could still circumvent these provisions by the use of rejectable offers and/or renewal option clauses.

(b) Although the determination of the capital cost of property would be the same as under (former) section 18 (i.e., it would be the sum of all the rental payments plus the terminal payments on exercise of the option), abuses would be avoided since the incentive for such artificial transactions would be eliminated by limiting the deduction in respect of capital cost allowances as outlined above. In addition, as contrasted to alternative (1), the transaction would definitely be drawn under the provisions of the Regulations on capital cost allowance and, therefore, subject to the limitation with respect to the deductibility of the cost of non-depreciable property.

(c) An exemption for bona fide business transactions is provided which is reasonable, since it is based on comparison of the option price with an estimated undepreciated capital cost for the property had it been purchased at fair market value at the time the lease arrangement was entered into. This would likely operate to exempt transactions wherein the lessor must treat the rented property as a capital asset as well. The provision runs into the problem associated with all fair market value rules: that is, the problem of determining fair market value.

Conclusion. Although this alternative would still not be satisfactory to the Department, it has the advantage of having been tested and proven effective against those arrangements wherein the taxpayer has an option to purchase the property. Having applied a ceiling to the amount of capital cost allowance that can be claimed, and having liberalized the qualifications required for exemption from the provisions of the section, it would now appear capable of effective operation and would be preferable to the untried and untested general provisions of sections 12(1)(b) and 12(2).

3. An adaptation of the United States tax treatment of leasing arrangements provides a third alternative. Basically, the United States provides a means whereby the facts pertaining to such transactions can be spread before the courts in order that they may distinguish between the genuine and the artificial. In Canada this would require the following amendments to the Income Tax Act:

(a) New section: All rental or other payments made for the purpose of obtaining title to property, and all such payments made for the purpose, or which have the effect of giving or transferring to the taxpayer an equity in property, shall be deemed to be a capital outlay, and shall be governed by the provisions contained in section 12(1)(b) of this Act.

(b) New subsection (16) to section 11: Rentals or other payments required to be made as a condition to the continued use or possession, for the purpose of the taxpayer's business, of property to which the taxpayer has not taken or is not taking title, or in which he has no equity.

(c) New section: For the purpose of this Act, the taxpayer has an equity in property if, amongst other things

(i) he has the right, contractual or otherwise, to acquire title to the property for less than its fair market value at the date title is acquired,

(ii) he makes payments for the use or possession of property, designated as rent or otherwise, which are in excess of a reasonable rental for the property in question,

(iii) he makes payments for the use or possession of property, designated as rent or otherwise, which on the happening of an event may be applied in whole or in part to reduce the purchase price of the property,

(iv) he has a right to the continued use or possession of property after the expiration of a fixed period, at a reduced or nominal rent which under the circumstances does not appear a fair or economic return on the value of the property at the time it is received.

(d) New paragraphs to section 20(6):

(i) Where a taxpayer obtains title to property, or obtains an equity in property as a result of making rental or other periodic payments therefor, the capital cost of the property to the taxpayer shall be deemed to be its fair market value at the time the property came into the taxpayers' possession.

(ii) The fair market value of the property referred to in the preceding subsections shall be established with reference to the market value of similar property in a like condition or locality,

and may be determined with or without reference to the particular agreement entered into by the taxpayer.

(e) The provisions of (former) section 18 governing non-arm's length transactions and the disposal of lease-option property would be adequate for purposes of any new section.

Analysis

(a) The proposed new subsection to be added to section 11 follows the general wording of section 162 of the Internal Revenue Code of 1954, which allows a deduction for all ordinary and necessary expenses incurred in carrying on a trade or business, including rentals. The proposed subsection would not be qualified by the "ordinary and necessary" tests found in the United States Code, but this qualification does not appear to have played any significant part in interpreting the meaning of the section. By copying the language used in the United States Code, we are able to use the interpretation of their courts which is reasonable and logical in limiting the abuse of tax avoidance, while retaining sufficient flexibility to meet the bona fide requirements of the business community.

Under the United States interpretation, the mere existence in the leasing agreement of an option to purchase will not convert a genuine rental payment into a payment on account of capital. If, at the time the lease is entered into, the parties intended to lease the property, then the payments are deductible as rent even though the option to buy is subsequently exercised. However, in judging the genuineness of the intention to lease, the court will

look to (a) the adequacy of the rent, as rent, and (b) the adequacy of the purchase price contained in the option. Where the rental is reasonable, and the purchase price approximates fair market value at the time it is exercised, the court will treat the prior payment as rent, and allow the deduction. 5/

It would appear that the proposed legislation would adequately exempt bona fide business transactions and arrangements wherein the tax advantage to the lessee is offset by the tax disadvantage to the lessor.

(b) Where the rent paid is higher than normal, and where the terminal payment is disproportionately low, the United States courts have not hesitated to look through the transaction. Thus, where a taxpayer "leased" machines for knitting full-fashioned hosiery for thirty months at a rental of \$800 a month, the court found that the transaction was, in fact, a time purchase of the machinery. 6/

The terminal payment, in this case, was only 11% of the total paid under the agreement. When this was taken into consideration, and the period of the lease compared with the useful life of the machines (probably ten or twelve years), it immediately became apparent to the court that the purchaser had obtained the machines under the option at a price substantially below their fair market value. The court reasoned that under the "rental" payments, the "lessee" or a purchaser had obtained an equity in the property.

The veidence...indicates that at the end of the year 1921 the petitioner had a substantial equity in these machines....

We do not know at what amount these machines could be rented on the open market, but we know that the total amounts to be paid under the lease agreements before the title to the machines was to pass to the petitioner exceeded but slightly the stated value of the machines, and it is inconceivable that the petitioner was not acquiring something of value, that is, a certain equity in the machines, with each payment made in accordance with the agreement. U

If the Canadian courts will accept the United States jurisprudence, the proposed amendments will provide the Department with the means of blocking tax avoidance schemes through the use of lease arrangements regardless of the form of contract. It will allow the Department and the courts to look through the form of the contract to the substance thereof.

Because the United States courts, when talking about a taxpayer acquiring an "equity" in property, base their reasoning on the common law or statute law of their particular jurisdiction, it is necessary for our purposes to state in fairly precise terms what is meant by acquiring an equity in property. Amendment (c) attempts to do this by incorporating into our statutes the rationale behind the United States tax decisions.

(c) Amendment (d) provides the Administration with the means of establishing the capital cost of property caught by the section. Under the proposed rules of fair market value, the monstrous distortion found in the Harris case, 8/ would not be repeated. These two subsections make the value of the property for the purposes of capital cost allowance a question of fact. If the agreement between the lessor and the lessee appears to be at arm's length and otherwise fair and reasonable, it can be used to

establish the value for depreciation purposes, much in the same manner as (former) section 18. On the other hand, it would, in the Harris situation, allow the court to look to the fair market value of the depreciable property in question. The court is not bound by the agreement between the lessor and lessee, but can take into consideration independent evidence to decide on the fair market value of the property in question.

(d) The proposed amendments, in effect, provide for ministerial discretion, subject to review of the courts. The "presumption of correctness" which was embodied in the majority of provisions providing for ministerial discretion in the old Income War Tax Act will not be present in this case.

Conclusion. It would appear that this alternative would effectively close the loophole whereby taxpayers are able to avoid the provisions of the capital cost allowance system by acquiring properties through leasing arrangements.

4. A fourth alternative would be to prevent inventory treatment on the disposition of property by the lessor.

(a) Where depreciable property which would otherwise be included in inventory of the taxpayer is leased to another person, there shall be to the taxpayer a deemed sale of inventory and acquisition of depreciable property at fair market value at the commencement of the lease. This will place the lessor in the same position in respect of capital cost allowances as would be the case had the lessee purchased the property. In a few cases depreciable property

is hardly ever sold, and fair market value would be extremely difficult to determine; at the same time, however, its determination would be less important.

(b) Such property shall continue to be treated as depreciable property until it is disposed of, and the disposition will be treated in the same manner as the disposition of any depreciable property. If the rents have been partly on account of the purchase price, the proceeds of disposition would be less than the undepreciated capital cost, and the taxpayer would still have a balance to claim in the future. If the rentals have been bona fide rentals, the proceeds of disposition would cover the undepreciated balance.

(c) For the purpose of provision (a), the profit on the deemed sale will be taken into income in a manner similar to that of an instalment sale subject to a special reserve to avoid taxation of a deemed profit before realization.

5. Still another alternative would be to force a lessee to recognize the fair value of the property if he acquires it at the end of the lease.

(a) Where property which has been leased by a taxpayer (or by a person with whom the taxpayer does not deal at arm's length) is acquired by the taxpayer at less than fair market value, the taxpayer shall be deemed to have acquired such property at its fair market value, and the excess of the fair market value over the cost of acquisition shall be included in the taxpayer's income in the year of acquisition. This provision is aimed at the actual transaction which is essential in an acceleration of allowances—

transfer of title at less than fair market value. From the lessee's standpoint, some acceleration would already have taken place in the form of high rents; such high rents would, however, have been reported as income by the recipient. Fair market value could be difficult to determine, but should be a sufficient test to prevent undue acceleration.

(b) Where the fair market value of the property at the commencement of the lease by the taxpayer (or by a person with whom the taxpayer does not deal at arm's length) can be determined, the fair market value for purposes of the above provision shall not be greater than, (1) in the case of land, the fair market value at the commencement of such lease, and (2) in the case of depreciable property, the amount equal to what would have been the undepreciated capital cost of the property if (i) the taxpayer or a person with whom he does not deal at arm's length had purchased the property at its fair market value at the commencement of the lease, (ii) the property had been in a separate class, and (iii) maximum capital cost allowances had been claimed in respect thereof. The extent to which rents have been on account of the purchase price of the property should be measured in relation to the fair market value of the property at the commencement of the lease. Such fair market value may not always be known to the lessee or capable of being established, and, accordingly, this measurement is not always possible.

Comments on Alternatives (4) and (5)

In alternative (4) the deemed sale of inventory at commencement poses difficulties because of (a) ascertainment of fair market value; (b) the appropriate spreading of deemed profit as rental payments are received; and (c) the deemed profit would likely be accrued faster than related cost which is being written off on a depreciable asset basis. In alternative (5) the same problem of ascertaining fair market value arises only where option is exercised but it is more difficult to establish since adjustment is in the lessee's return.

In alternative (4) the balance of cost remains to be claimed by lessor who no longer owns or uses the asset, while in alternative (5) the balance of cost is to be claimed by the new owner of the asset.

In alternative (4) the slow write-off to the manufacturer would be particularly objectionable if an overall loss was incurred in respect of the property, but in alternative (5) the lessee could hardly object to the slow write-off.

The proposal in alternative (4) would not be appropriate for dealing with leased land for which the deduction would have to be immediate or not at all. If immediate, then the only value of the land not yet claimed for tax purposes would be the option price paid by the lessee. The alternative of no deduction at all would be completely unfair to the lessor, since his cost would not be recognized. However, in alternative (5) this proposal would be suitable for land, since the lessor would have reported his net income (assuming the sale of land was taxable to him) and the lessee would be forced to set up as land cost the portion of rents attributable thereto.

General Observations

Because lease options are very common and appear in many forms, the numerous solutions suggested tend to be directed at specific types and overlook many variations. Experience in the United Kingdom and the United States indicates that Canada is not alone in the search for answers to the many complications and uncertainties which are inherent in this hybrid legal concoction. Many of the problems arise because the mixed concepts of ownership, sale, lease and purchase are thrown together without obvious resolution.

So long as we adopt the attitude, as often expressed in the courts, that the form shall prevail, we shall forever be confronted with the problem of how the Revenue will prevent a lessee-purchaser from obtaining a quick write-off of a capital asset where excessive rent payments are really, in fact, capital payments on account of the purchase price of the subject assets.

The strict view would appear to be that the payment ultimately made on exercising the option, as well as any lump sum payment, which is made at the outset, are capital payments and not deductible in computing the taxpayer's profit, although they may entitle the taxpayer to capital cost allowances, while the periodic payments, being expressed as rent charges, are deductible and so are not eligible for capital cost allowances. Admittedly this basic approach, as attested by the experience of the Department of National Revenue both before and after the advent of the now defunct section 18, leads to many forms of abuse.

At one end of the scale of solutions we have the completely arbitrary method of permitting the Minister to look through the transaction and of

deeming the lessee's position to be that of a purchaser; capital cost allowance would then be allowed on only those payments which are actually made. This is too rigid an approach and, no doubt, would cause serious hardship; it would have a generally disruptive influence on bona fide business transactions.

It is necessary, therefore, to obtain a solution which is neither so liberal as to permit illegitimate deductions by way of quick write-offs of capital assets, nor so harsh as to discourage this type of transaction by refusing to allow bona fide rent deductions, as was the case under the former section 18. However, as can be seen by the many suggestions advanced, a solution is not readily available. This state of affairs can, for the most part, be blamed on the amorphous nature of the lease option. It is two different things at the same time.

There is one element which is critical; if we are to obtain a workable solution to the problem, a fair and reasonable determination of what would otherwise have been the purchase price of the asset at the outset must be ascertainable. If this were available, the assessor would be in a more satisfactory position to determine whether the actual rental is disproportionate to the rental value. Furthermore, a comparison of the undepreciated capital cost at the date of the exercise of the option with the terminal or purchase price would readily indicate if the disparity between fair rental and actual rental was attributable to a low terminal outlay.

In the United Kingdom, the Revenue practice in these cases is to ascertain what the price of the asset would have been had it been bought for cash, and to calculate the difference between that sum and the total payments due throughout the agreement. This difference, apportioned

actuarially over all the payments, is treated as if it were interest and deductible in computing profits as and when paid, the balance of each of the payments being treated as capital expenditure and non-deductible, but qualifying for capital allowances on the basis that it was spent in the year of payment and that the hirer was the owner. 9/

This approach is predicated on the assumption that the fair market value can be readily ascertainable at the outset. This is generally a correct assumption when dealing with a single asset, but what of the situation when the lease option is for land and buildings or buildings and their contents? The total fair market value of the combined assets may be ascertainable, but what may be fair market value of the building to the purchaser may be totally different from the fair market value ascribed to the building by the vendor. Whose valuation do you use? Unfortunately, it is in questions concerning lands and buildings, on which latter assets a 5% capital cost allowance is permitted, where our major problem lies. The rates of capital cost allowance on machinery has risen in recent years to sufficiently high rates so as to dilute the attractiveness of a lease option quick write-off for this type of asset. 10/ Since there is no readily available indication of what would otherwise have been the cost of the assets had the lessee decided to purchase them, the assessors are left to their own resources in determining cost. This leads to many divergent opinions as between assessor and taxpayer as to what would have been the cost if a purchase had taken place and, more especially, what should be the fair rental assuming fair market value is a known quantity.

We may find some solace in the attention directed by the Royal Commission toward a tax on all land transactions. It is not known whether this is to be at full or modified rates. However, if such a tax is to be

levied, we may find that this will tend to force taxpayers to allocate more of the purchase price in a lease option to land in order to enhance its cost in anticipation of a profit on its sale. This would have a desirable effect if taxpayers reduced the amounts of rent to be paid on land and added the reduced rent to the terminal price. Whether or not this will, in fact, occur remains to be seen. How much it will reduce the rental on buildings to a more reasonable rate and increase the terminal payment in the hope of a greater allocation to the cost of land is not known.

Admitting a perplexing problem and ruling out arbitrary methods which would treat transactions by "deeming provisions" as being something they are not, 11/ what can be suggested by way of amendment to existing legislation which will assist the Revenue in minimizing tax avoidance schemes which are intended to accelerate deduction of capital costs? The addition of the following provisions should assist the Revenue in preventing avoidance schemes.

1. Where the option price is to be reduced by the amount of the rental payments, then the total of the rents paid and the option price shall be treated as the capital cost. The lessee-purchaser will be refused deduction of any or the payments as rent and will be allowed capital cost allowance on amounts actually paid.

2. Where the amount paid or payable by the lessee as rent is in excess of the fair market rental at the time the agreement is entered into, the amount of such excess shall be deemed not to be paid or payable on account of rent, but shall be deemed to be paid or payable on account of the purchase price of the leased assets for purposes of determining the taxable income of the lessee-purchaser.

3. Extend the provisions of section 17, which deals with non-arm's length purchases only, to include rents, royalties, management fees, payments for services or for the use or production of property.

4. The purchaser may allocate part of the rent to capital cost and deduct capital cost allowance annually against this portion. If the lessee does not allocate any of the rent to capital cost in any one year and it is found by the application of paragraph (2) above that part of the rent paid in that year is attributable to capital cost, then the lessee-purchaser will be allowed to claim capital cost allowance against the disallowed portion of the rental only if the lessee exercises the option to purchase.

5. If the lessee does not in fact exercise the option, then the lessee will be allowed a terminal loss when the property reverts to the lessor to the extent of the capital cost which has not been written off.

6. If the lessee disposes of his interest in the option than the consideration received will be recaptured to the extent that it exceeds the capital cost allowance which has been taken.

7. If the lessee sells his interest in the lease then the consideration received will be treated as a capital receipt. (However, we are still faced with a serious problem of allocation when the lease and the option are disposed of together.

8. Leasehold improvements would be treated in the usual manner.

9. On the death of the lessee-purchaser, if the lease option is not terminated, the heirs, executors, administrators and assigns would be treated as standing in the exact same position as the deceased to avoid any possible complications through the application of section 20(6)(c).

Conclusion

If the aforementioned suggestions are implemented they would greatly assist the Department in ferreting out avoidance schemes. It is probably safe to say that no scheme should be adopted which, in a wholesale fashion, deems things to be something they are not, for when this is done, as was the case in the defunct section 18, the legislators are never able to envisage all ramifications and contingencies and as a result, the approach inevitably disintegrates.

NON-ARM'S LENGTH TRANSACTIONS

The Problems

1. Although officials of the Department of National Revenue consider that the rules governing non-arm's length transactions are operating satisfactorily to prevent tax avoidance schemes (e.g., as in the Pioneer Laundry case), there appears to be one way in which it may be used by taxpayers to avoid tax.

Where two companies are not dealing at arm's length for purposes of section 20(4), and one is in a loss position and the other in a profit position, it may be possible, through the operation of this section, for the profitable company to transfer a portion of its profits to the loss company and thus avoid tax thereon. This would be accomplished by the transfer to the loss company, at a nominal price, of all the assets in a certain class (or in all classes) of the profit company. This would create a large terminal loss for the profit company which it could set off against its other income.

the loss company would acquire these assets at a nominal capital cost and would also be deemed to have accumulated capital cost allowances equal to the amount by which the capital cost of the assets to the profit company exceeds the actual capital cost of the property to itself (section 20(4)(b)). Although this deemed accumulated capital cost allowance is intended to create an allowance in the hands of the purchaser for purposes of recapture (section 20(1)), so that it may be recaptured, in the hands of the loss company any such recapture can be set off against the company's losses. It would appear, therefore, that under certain conditions a profitable company could create a terminal loss which it could offset against other income by transferring assets at nominal prices to an unprofitable related company. 12/

It would appear that the Department of National Revenue could only block such tax avoidance schemes by arguing that it is an artificial transaction (section 137(1)), or that one of its main purposes is to improperly avoid or reduce taxes which might otherwise be payable (section 138(1)). Section 137 would not likely be applicable because it would be difficult to argue that a transaction is artificial when it is specifically contemplated by another section of the Act, and section 138 is not often used.

2. Taxpayers who are related for purposes of the Income Tax Act, but who enter into a transaction without the motives contemplated by the rules governing non-arm's length transactions may be handicapped because of the provisions of section 20(4). Related taxpayers who engage in a transaction for the sale and purchase of depreciable property are caught by the provisions even though they are acting independently of one another. The purchaser may only claim capital cost allowances on

the capital cost of the property to the vendor, even though he had to pay the fair market value which may have been in excess of that capital cost. In addition, if the asset is purchased for less than the capital cost to the vendor the purchaser may suffer recapture of capital cost allowances actually claimed by the vendor.

3. The Joint Committee representing the Canadian Bar Association and the Canadian Institute of Chartered Accountants 13/ point to another possible inequity arising from the rules governing non-arm's length transactions. "In cases where depreciable property is transferred from one taxpayer to another in a non-arm's length transaction it is often difficult to do so without either giving rise to recapture of depreciation or having the vendor confer a benefit on the purchaser. In cases where the depreciable property to be sold is worth more than undepreciated capital cost, recapture may arise if the property is sold for its fair market value. If the property were to be sold at less than fair value (for example at undepreciated capital cost) the vendor would be protected from recapture by virtue of section 17(7) but the transaction might be said to result in a benefit to the purchaser, in which case the provisions of section 8(1), section 16(1), section 81(1) or section 111 might apply depending on the circumstances".

Alternatives

The present provisions of section 20(4) operate effectively in the majority of cases; however, the loopholes and inequities discussed remain to be dealt with.

1. Amend section 20(4) to allow the Minister to waive its present provisions and substitute a rule of fair market value comparable to

those found in section 17(1) and (2) of the Act, when, in his opinion, the present provisions result in tax avoidance or hardship.

Analysis

(a) Although ministerial discretion in this case would effectively close the loophole and give relief to the inequities which occasionally occur under the present provisions of section 20(4), such an amendment would appear to be rather drastic. Ministerial discretion in general was very heavily criticized in the old Income War Tax Act and it is unlikely that taxpayers would be receptive to its introduction in this problem area.

(b) Although ministerial discretion ordinarily introduces simplicity and administrative ease into the law, it also creates a degree of uncertainty from the point of view of the taxpayer. The taxpayer would not be sure that the Minister would elect to exercise his discretion, and even if he did so exercise his discretion, he is still confronted with the problem of determining fair market value which may often be very difficult when dealing with depreciable assets.

2. The Joint Committee 14/ recommended that "...when depreciable property is transferred between persons not dealing at arm's length under such circumstances that section 20(4) is applicable to determine, for the purpose of section 11(1)(a), the capital cost of the property to the person by whom the property was acquired, the purchaser and the vendor be permitted to make a joint election as to the portion of the consideration that is allocable to the depreciable property which would then be deemed to be 'proceeds of disposition' [for purposes of section 20(1)]

for the vendor and 'actual capital cost' [for purposes of section 11(1)(a)] for the purchaser and that the portion of the consideration actually paid which is in excess of the deemed proceeds of disposition and actual capital cost be deemed to be in respect of non-depreciable property".

Analysis

To this recommendation should be added a qualification that "provided that the consideration allocable to depreciable assets cannot be less than the lower of undepreciated capital cost or the fair market value of the assets". This latter provision will serve to prevent forced terminal losses by the vendor.

If the recommendation as outlined in paragraph (2) above is used it will permit the purchaser to obtain a more reasonable base for capital cost allowance in excess of the vendor's undepreciated capital cost. The purchaser will not be burdened with a potential recapture of capital cost allowance taken by the vendor.

It was stated, however, in the reasons supporting this recommendation contained in the joint brief, that this suggestion would solve the problem of a benefit being conferred as outlined in item (3) on page 150 of this study. This is not a correct conclusion unless the election applies for all purposes of the Act and not just for purposes of sections 20(1) and 11(1)(a). Admittedly, the suggestion permits the vendor's base position to be transferred to the purchaser or, alternatively, provides a stepped-up basis for the purchaser, but the benefit provisions, that is, sections 8(1); 16(1); 81(1) and 111 may still apply unless an all-purpose qualification is added, or unless these benefit sections are expressly

precluded from application to the "proceeds of disposition" resulting from the allocation.

It is recommended, therefore, that sections 8(1), 16(1), 81(1) and 111 be amended to prevent their application where elections have been made under section 20(4).

Farming and Fishing and
Section 20(4)

By virtue of section 85H the application of section 20(4) is expressly precluded from sales of farms or fishing vessels by farmers or fishermen to their offspring. In this manner, the farmer's basis for capital cost allowance is not transferred to the child and thus, the child is permitted to obtain a stepped-up basis for purposes of section 11(1)(a) equal to the lesser of capital cost of the depreciable assets to the child as determined by section 20(6)(g) or the fair market value thereof.

It has been suggested that farmers and fishermen be required to adopt the reducing balance method of calculating capital cost allowance and that they become subject to the provisions of section 20(1) and Regulation 1100(2) which impose recapture and permit terminal allowances.

Furthermore, it has been suggested that section 85H is an unfair concession to farmers and fishermen and that the section should be abolished. This would place other small businesses on an equal footing with farmers and fishermen. Under section 85H, a child would have to pay to the parent, as consideration for the farm or the fishing vessel, a sum in excess of the undepreciated capital cost of the asset, in order to obtain a stepped-up basis. The same result would follow from the recommendations which are

made above, in connection with section 20(4), that is, if vendor and purchaser elect they can allocate part of the consideration to the depreciable property in excess of the undepreciated capital cost of the depreciable assets. If this latter recommendation is accepted, there is no reason to maintain section 85H since the same effect can be obtained by an election under section 20(4) as amended.

INSURANCE PROCEEDS: SECTION 20(5)(c)(iii), 20(5a)

The Problem

The proceeds of any insurance on a destroyed building which are in excess of the undepreciated capital cost of the building are not subject to recapture if a building of the same or of a different prescribed class is constructed in the year following the destruction of the original building, whereas the excess proceeds are subject to recapture if the new building which is constructed is in a different prescribed class and is built in the same year in which the original asset was destroyed. This difference in treatment of excess proceeds from insurance is unreasonable and appears to be unintended.

Alternative

Section 20(5a)(a) should be amended so that proceeds may be deducted from the cost of a new building of a same or a different class built in the same year or in the year following the destruction of the original asset.

DISPOSAL BY WILL

The Problem

Depreciable property which is disposed of by will escapes recapture of capital cost allowance (section 20(6)(d)) and is acquired by the legatee at

fair market value (section 20(6)(c)). Section 20(6)(d) provides that where a taxpayer has given property away he shall be deemed to have disposed of it at the time of the gift at fair market value. Because of the exception in the case of bequests by will, recapture is avoided in the hands of the deceased or of his estate. In addition, if the undepreciable property is held in a trust or an estate for a time, the trust or estate is entitled to claim capital cost allowances in respect of such depreciable property based on the fair market value at the time of death. These allowances may be deducted from the income of the trust or estate or from the income of the beneficiaries. If the depreciable property is sold by the trust after capital cost allowances had been claimed, there is a recapture or terminal loss according to the circumstances. If, however, such property is not sold, but is held until distributed to the beneficiaries as a distribution of the estate or trust, the present law does not authorize any recapture or terminal loss. It would appear possible, under these circumstances, for a property to be depreciated twice without being subject to any recapture (i.e., once for the deceased and once for the trust or estate).

This tax treatment of depreciable property disposed of by will is substantially different from the treatment of depreciable property disposed of by any other means (e.g., by gift) and represents a departure from a basic principle of the system which limits allowances to the capital cost to the taxpayer. Objections have been voiced that this is an unnecessary benefit extended to deceased taxpayers and that property of the deceased should be deemed to have been disposed of at fair market value.

Alternative

If this suggestion were followed it would effect hardship on the deceased taxpayer's estate by placing a heavy burden on the liquidity of

the estate at a time when estate tax and succession duties will also be straining the cash position.

It has been further suggested that the deceased taxpayer's position vis-à-vis capital cost allowance be transferred to the beneficiaries under a will. This, it is said, provides a continuous base for income tax purposes and avoids recapture in the deceased's estate. However, from the point of view of the beneficiary, it would more than likely force recapture in his hands. Is it equitable to penalize the beneficiary for an allowance granted to his predecessor, especially when the Revenue has exacted its toll in death taxes at the time that the bequest crystallized? What assurance is there that the price received on disposition by the beneficiary of the depreciable assets will not reflect an inflationary factor?

In addition, section 58(1)(s)(ii) of the Estate Tax Act and, generally speaking, the provincial succession duty acts provide for a levy to be made on the fair market value of the assets in the estate. To levy a progressive income tax at the time of death on the estate of the deceased or on the beneficiary on the disposition by him of the depreciable assets would be tantamount to double duty which, in many instances, would be devastating.

It is not recommended that either section 20(6)(c) or (d) be amended.

PROCEEDS OF DEPRECIABLE AND NON-DEPRECIABLE PROPERTY

The Problem

Although the rule calling for the apportionment of the proceeds from the joint sale of depreciable and non-depreciable property appears to be necessary in order to protect the Revenue from a loss of recapture in an

arm's length sale, there is one application of the rule which has become quite controversial and appears to be inequitable.

If a building is sold to a purchaser who intends to demolish the building, the vendor is considered by the administration to have sold depreciable property and land and an apportionment of the proceeds between buildings and land must be made. The taxpayer may suffer recaptured depreciation accordingly. On the other hand, if the vendor in contemplation of the sale has the building demolished by the salvage company, receiving only the proceeds from salvage, no part of the proceeds from the sale is apportionable to buildings and the vendor will probably be entitled to a terminal allowance on the sale. There is obviously a substantial difference in the tax position of the vendor according to which of the two courses of action he takes. 15/

To date, the Tax Appeal Board has been inconsistent in its rulings on the question of apportionment of proceeds from the sale of land and buildings where the buildings are to be demolished by the purchaser. In both the Chess 16/ and Marsh 16/ decisions the Board, for some strange reason, which is not supported by the wording in section 20(6)(g), adopted the position that the transaction should be looked at primarily from the point of view of the vendor, and any indication of what the purchaser was in fact paying for was of secondary consequence. However, this approach was not adopted in Steen Realty Ltd., either at the Board level or by the Exchequer Court. 17/

In Steen Realty, 18/ the vendor sold three old buildings which were to be demolished by the purchaser for purposes of constructing an office building. The court considered the fact that what the purchaser was paying for was land. The buildings were old and were rapidly becoming uneconomical from the point of view of the vendor's investment. In the result, no part of the proceeds were attributed to the buildings.

It is difficult to say whether the Steen Realty decision will henceforth be followed; it does, however, provide authority for the proposition

that allocations between depreciable and non-depreciable property will take into consideration the purchaser's considerations as to what he is paying for as well as the value of the depreciable asset to the vendor—an eminently more realistic and equitable approach.

Inasmuch as there is an obvious conflict between the purchaser and the vendor in these cases, it seems unfair to base the allocation upon considerations affecting the vendor only. The Revenue is anxious to see that the vendor does not avoid what would otherwise be a situation inviting recapture. In adopting this one-sided approach, the Revenue is directly assisting a purchaser who is, in fact, only purchasing land. By allocating more to depreciable property, the probability of recapture in the hands of the vendor is increased; however, the purchaser may be given the benefit of something he really did not intend to have by way of capital cost allowance and/or terminal allowance. Thus, it can be seen that the best method would seem to be to look at the situation both from the point of view of the vendor and the purchaser and then arrive at a decision which would be equitable to both parties as evidenced in the Steen Realty case.

This, however, may be easier said than done. For example, the vendor may legitimately be of the opinion that the depreciable assets are worth \$10,000 and the purchaser may also legitimately be of the opinion that these assets are worth \$20,000. Both may have bona fide and reasonable arguments for their separate allocations.

Alternative Approaches

The merits of alternative approaches, under different tax systems, may best be reviewed by considering the different circumstances under which transactions in land and buildings can take place.

1. Where the land and buildings continue in use, neither having been subject to material changes in value,

(a) the present tax system makes the land non-taxable but the buildings taxable up to the original cost. If the vendor wishes to minimize recapture of depreciation, he emphasizes the value of the land. But if the purchaser wishes to maximize his depreciable cost, he emphasizes the value of the buildings. One alternative to these approaches would be to have a reasonable allocation for each. Some honest difference of opinion might ensue and opinions would be stretched for tax purposes perhaps causing undue administrative difficulty. Another alternative would be to have the same allocation for each. An agreement signed by each as to the allocation for tax purposes would be workable and save administrative difficulty.

(b) If the buildings are fully taxable but the land has a time exemption, there is no possibility of capital gain on buildings under this example, therefore there are no different considerations.

(c) If the buildings are fully taxable, and the land subject to some tax, the same general consideration would apply as at present, but the importance of the allocation is reduced.

2. Where the land and buildings continue in use, both having increased substantially in value,

(a) the present tax system makes the land non-taxable but the buildings taxable up to the original cost. If full recapture by the vendor of depreciation is inevitable, allocation does not matter, but the purchaser will wish to maximize his depreciable cost; therefore he emphasizes the value of the buildings. One

alternative would be to have a reasonable allocation for each, in which case there could be considerable honest differences of opinion between vendor and purchaser as to a proper allocation: and administration would be difficult. Another alternative would be to have the same allocation for each. It might be possible to have the parties sign an agreement for tax purposes; however, since there is no conflict of interest between the parties, the value of the buildings would be overstated.

(b) If the buildings are fully taxable but the land has a time exemption, the same considerations would apply as with a partial recapture under the present tax system in situation (1) except that there would be more difficulty in forcing the parties to sign an agreement.

(c) If the buildings are fully taxable, and the land subject to some tax, the same comment applies as in (b) except that the importance of the allocation would be slightly reduced.

3. Where the buildings are to be torn down, but are still of some economic use to the vendor,

(a) the present tax system makes the land non-taxable, but the buildings taxable up to original cost. In this case the vendor will want to allocate none of the proceeds to the buildings, but the purchaser will want to try to allocate some of the purchase price to buildings. One alternative would be a reasonable allocation for each. The results would (and probably should) be quite different for each party; and administrative difficulties would be significant. Another alternative would be to have the same allocation for each, but it would be unrealistic to force them to

agree on a common allocation. Of course, the vendor can avoid any recapture if he tears down the buildings before the sale.

(b) If the buildings are fully taxable but the land has a time exemption, this is not applicable, since there would not likely be any possibility of a capital gain on the sale of the building.

(c) If the buildings are fully taxable, but the land subject to some tax, this reduces the importance of the allocation, but it would still be significant because of the difference between the rate of tax on the building proceeds and that on the land proceeds.

4. Where the buildings are to be torn down, and of no economic use to the vendor, no problem arises as the value is attributable to the land for both parties.

Observations on Transactions in Land and Buildings

Matter of opinion. The appropriate allocation of value between land and buildings is very much a matter of opinion, and there can be considerable honest difference of opinion between a vendor and purchaser.

Self-policing. There is some conflict of interest between the vendor and purchaser in the allocation between land and buildings for tax purposes. This conflict would be intensified if proceeds from buildings were fully taxable. This suggests the possibility of having the two parties agree on an appropriate allocation for tax purposes. Such an approach would, however, be quite unnatural and objectionable.

Tax treatment of land. The less preferential the treatment of the land, the less important the allocation between land and buildings.

Basic economic value. The essential allocation of value between land and buildings would seem best indicated by the allocation in the mind of the purchaser, which would depend on the use to which the property is to be put.

This proposition explains an anomaly in the present tax treatment of a sale where the buildings are still of use to the vendor but are going to be torn down by the purchaser. If the vendor arranges to tear the buildings down first, (or sell the land separately from the buildings, which is difficult but not impossible) he suffers no recapture; if the buildings are torn down after the sale (where sold with the land), there is recapture.

Alternatives

1. Separate allocations reasonable to each party:

- Pro: (i) Most appropriate to the facts.
- (ii) Would not interfere with business procedures.
- (iii) Unless there is potential for significant abuse and administrative difficulty, this is the appropriate procedure.
- (iv) Avoids implication that one taxpayer's file can be used to check or assess another's.

- Con: (i) Allocation may exist mainly in minds of parties, and would create administrative problems.

2. Same allocation for each party:

- (a) By common agreement for tax purposes:

- Pro: (i) Conflict of interest (assuming entire proceeds from building taxable) keeps allocation honest.

- (ii) Avoids administrative difficulty.
- (iii) Adds certainty in the minds of the parties.

Con: (i) Allocation could be artificial to take advantage of differences in tax position of two parties.

(ii) Interferes with usual business procedures.

(b) From purchaser's standpoint:

Pro: (i) Reflects basic economic value, thereby avoiding anomalies because of procedures followed.

Con: (i) Economic value is different for the two different parties.

(ii) Could force vendor into larger recapture than anticipated unless declaration made at time of negotiation.

(c) By some other arbitrary rule, for example, municipal tax assessments, present tax values, etc.

These do not appear to provide a method of allocation which would give reasonably consistent results.

SEPARATE CLASSES OF DEPRECIABLE ASSETS

The Problem

By virtue of Regulation 1101(1) a taxpayer is required to place property in separate classes even though such property would otherwise be included in one class if the various properties are used in separate businesses. In other words, a taxpayer, in addition to classifying his assets into the various prescribed Classes 1 to 23, must classify assets

by businesses. Furthermore, assets used in separate businesses and assets used merely for the purpose of obtaining income from property, that is, rental income, etc., must be distinguished.

The reason for this Regulation is to prevent taxpayers, such as proprietors and partners, who are involved in several businesses with different years ends from claiming capital cost allowance on the same assets more than once in preparing financial statements for each separate business. If a proprietor is involved in several businesses and also has rental income from real estate he could conceivably, in the absence of Regulation 1101(1), obtain a capital cost allowance more than once on the same class of property by claiming that the property was being used for each business as well as to earn rental income.

It should be noted that Regulation 1101(1) cannot be abused by corporations since they have but one year end and are therefore not able to "juggle" class calculations in the same manner as individuals and partners.

If the taxpayer owned all the businesses and the property outright, a solution to the problem would be to allow all of the capital cost allowance as a deduction from personal income on a calendar year basis. However, this is not possible where the taxpayer is in partnership with others, each with his own particular tax rate and problems. The solution, therefore, is the separation of classes as required by Regulation 1101(1).

Although introduced to make the capital cost allowance system workable, the Regulation is also important because of its effects on the recapture provisions. Thus, if a taxpayer who owned and operated a hotel sold the property and reinvested the proceeds therefrom in another hotel, in the

same taxation year, regardless of the provisions of section 20(2), he was subject to recapture of capital cost allowances on the first property, since it would be considered to form a separate class by reason of Regulation 1101(1). Although the Regulation works to the disadvantage of the taxpayer if there is recapture, it works to his advantage where he has a terminal loss on disposition since he is able to claim the loss immediately rather than by amortizing the balance at the class rate.

Because of the importance of Regulation 1101(1) to the operation of the capital cost allowance system, the recent decision by the Tax Appeal Board in Touzeau v. M.N.R., 19/ in declaring this Regulation ultra vires, has resulted in an anomaly which should be removed.

Alternatives

1. The Minister is appealing the decision of the Tax Appeal Board to the Exchequer Court. It would appear that such an appeal has a reasonable change of success since the Board's decision is based on its interpretation of what constitutes a prescribed class for purposes of section 20(2).

Analysis

The Board suggests that the Governor in Council, in formulating regulations with respect to capital cost allowance, was entitled to specify the classes of property which would be entitled to certain specific rates of deduction in respect of capital cost allowance, but once having done so, is not entitled to subdivide these classes as has been done in Regulation 1101(1).

There would appear to be no such restriction placed on the Governor in Council by sections 117(1)(a) and 11(1)(a) of the Income Tax Act which

provide the Governor in Council with the general authority for formulating Regulations in the first instance and, more especially, with respect to capital cost allowances. The authority for the Regulation wherein the classes are prescribed is not found in section 20(2) but in section 11(1)(a). This latter section allows any Regulations to be formulated which are necessary to the operation of the capital cost allowance system, provided they are not in contradiction with specific sections of the Act. The Regulations proceed to provide for the grouping of depreciable property into classes as set out in Schedule B of the Regulations and subdivisions or groupings thereof as provided in Regulations 1101 and 1103. Regulation 1105 provides that the classes of property provided in the Regulations and in Schedule B thereto are prescribed for purposes of section 11(1)(a) and section 20 of the Act. Section 20(2) of the Act merely refers to these prescribed classes which would include those classes provided by Regulation 1101.

Conclusion. A reversal of the Tax Appeal Board's decision by the Exchequer Court would be desirable to clear up the present situation.

2. If the Exchequer Court and the Supreme Court uphold the decision of the Board, it will be desirable to reinstate the position of Regulation 1101 through an amendment to the Act. It would appear that this can be done by transferring Regulation 1105, which prescribes the classes for purposes of the Act, from the Regulations to the Act.

INCLUSION OF OTHER PROPERTIES IN CLASSES 1, 2, 4 AND 17

The Problem

It is understood from the officials from the Department of National

Revenue that Regulation 1103 was meant to provide the taxpayer with a means of simplifying the computation of capital cost allowances, and not to allow him to defer recapture of depreciation. However, it would appear that the majority of elections made under Regulation 1103 have been for the latter purpose. Although the decision in G.H.C. Investment Ltd. 20/ has substantially clarified this situation, there remains the possibility of deferring recapture through the provisions of this Regulation if the taxpayer makes an election before the sale of property which might give rise to such recapture.

Alternative

Since few taxpayers, if any, have used Regulation 1103 to simplify their computation of capital cost allowances, and it has been used, on the other hand, as a means of deferring recapture, it is suggested that Regulation 1103 be repealed.

ELECTION TO AVERAGE RECAPTURED CAPITAL COST ALLOWANCES

The Problem

The election under section 43 for the averaging of capital cost allowances recaptured in a taxation year, provides a taxpayer with a means of avoiding substantial additions to income in one taxation year which may seriously affect his tax liability in view of the graduated rates of tax applicable to both individuals and corporations. Such an averaging provision recognizes the fact that the recapture arises primarily because of excess allowances which have been claimed, not in one year, but over a period of years. The averaging provision, therefore, conforms with sound accounting practice.

The five-year limitation would appear to be reasonable inasmuch as it would be virtually impossible to allocate, with any degree of accuracy, the excess allowances to any particular taxation year. Although the period of five years is relatively short compared to the estimated useful life of many depreciable assets, it is a practical compromise from both the Department's point of view and that of the taxpayer.

The Joint Committee representing the Canadian Bar Association and the Canadian Institute of Chartered Accountants have pointed to one anomaly which arises from the present interpretation of section 43.

According to their information, "...assessments have been issued on the basis that, according to the provisions of paragraph (b) of subsection (1), where an election has been made under section 43 in one of the five years preceding the taxation year, another election made in the taxation year results in the taxpayer paying as part of the recapture tax of the current taxation year all of the saving that he had made by his election with respect to the first recapture. This is because the tax for the year of the first election was entirely recalculated on the basis of the first recapture being taxable as income of that year without the benefit of the spreading". 21/ Any such interpretation of section 43 would appear to be contrary to the original intention of its provisions.

Alternative

The Joint Committee has recommended "...that section 43(1)(b) be amended so as to make it clear that the computation of the aggregate of the amounts by which the taxpayer's taxes would have been increased for each of the taxation years in the period determined under section 43(2)

is to be made giving effect to previous elections made under section 43 in such period". 22/

Such an amendment would remove the present anomaly which arises from the provisions of section 43.

LEASEHOLD IMPROVEMENTS

The Problem

The present rules regarding the amortization of leasehold improvements are, perhaps, not precise enough in their treatment of an abandoned lease or in the apportionment of cost when a leasehold improvement is made during a year. Regulation 1102(5) provides that a lessee must include in Class 3, (5%), buildings which have been erected by the lessee on leased land. Since this provision does not extend to the sub-lessee, a sub-lessee may be able to obtain a quick write-off under Regulation 1101(1)(b) of a building which has been erected by the lessee on leased land. For that matter, the lessee and sub-lessee need not be dealing at arm's length; they could be parent and subsidiary.

Alternative

Regulation 1102(5) should be amended to apply to sub-lessees who acquire a leasehold interest in a building which has been constructed by the lessee.

TERMINAL LOSSES

The Problem

Under Regulation 1100(2), where a taxpayer suffers a terminal loss on

the disposition of depreciable property of a class or the transfer of the assets of one class to another class, such loss may be deducted from income for that taxation year. Terminal losses arise where there are no assets in a class at the end of the taxation year, after a disposition or transfer between classes, and the taxpayer still has undepreciated capital cost in his accounts pertaining to that class of assets.

Where a terminal loss occurs, the inference is that insufficient capital cost allowance has been taken over the life of the asset. It should be noted that under section 43(1) of the Act, where recapture of capital cost allowance occurs by virtue of section 20(1), 23/ then the taxpayer is entitled to spread back the recaptured allowance over the previous five taxation years and to pay tax at the rates otherwise applicable in those years.

Alternatives

1. It would seem inequitable and inconsistent not to treat recapture of capital cost allowance and terminal losses in the same manner. Therefore, it is recommended that terminal losses be spread back over the previous five years.

2. Inasmuch as a terminal loss indicates that greater depreciation has taken place than has been allowed for by the capital cost allowance rates, and since capital cost allowances may or may not be taken in the discretion of the taxpayer, it would seem that greater flexibility should be allowed in the application of the terminal loss. Notwithstanding recommendation (1) above, consideration should be given to the possibility of allowing the terminal loss to be applied in the taxpayer's discretion.

This would allow terminal losses to be treated in the same flexible manner as capital cost allowances.

DEPRECIABLE PROPERTY, INVENTORY AND CONVERSION

The Problem

"Depreciable property" is defined in section 20(5)(a) to mean property in respect of which the taxpayer has been allowed, or is entitled to, a deduction under the Regulations made under section 11(1)(a) in computing income for that or a previous taxation year.

"Property", by definition found in section 139(1)(ag), includes property, real or personal, corporeal or incorporeal, a right of any kind, a share, or a chose in action.

While the authority for the capital cost allowance is found in section 11(1)(a), the details of its mechanics are contained in the Regulations. The Regulations also exclude certain types of property from the benefit of capital cost allowance.

One of these exclusions is found in Regulation 1102(1)(b), that is, property that is described in a taxpayer's inventory. Inventory is defined in the Act in section 139(1)(w) as being a description of property, the value of which is relevant in computing a taxpayer's income from a business for a taxation year. Since this value is deductible as a direct cost of doing business, it cannot constitute a capital cost of property in respect of which further allowances would be in order.

However, there may be circumstances in which property can be both "inventory" and "depreciable property" at the same time. Should capital

cost allowance be permitted on such assets? For example, real estate in the hands of a dealer is, in a sense, his inventory, but if it is earning rental income in the meantime, capital cost allowance will be allowed (probably on the basis that the property is not described in an inventory). The allowance so permitted is later recovered in the form of a larger taxable profit upon the eventual sale, but it certainly is confusing and leads to inconsistencies.

As an extension of the aforementioned problem, we are confronted with the question of the proper treatment to be accorded a conversion of property of a capital nature to stock-in-trade, or a conversion of stock-in-trade to capital. Should effect be given to such conversions at cost price or undepreciated capital cost or at fair market value as of the date on which the change in character occurred? A priori we must deal with the question of whether a taxpayer is to be taxed on a transaction with himself. The United Kingdom courts, especially the House of Lords, have concluded in the case of Sharkey v. Wernher, 24/ that a taxpayer can make a profit on a transaction with himself.

In examining the Income Tax Act, we find two instances where conversion for purposes of section 11(1)(a) is deemed to take place at fair market value. These are found in section 20(6)(a) and (b) which read as follows:

20(6)

- (a) where a taxpayer, having acquired property for the purpose of gaining or producing income therefrom or for the purpose of gaining or producing income from a business, has commenced at a later time to use it for some other purpose, he shall be deemed to have disposed of it at that later time at its fair market value at that time;
- (b) where a taxpayer, having acquired property for some other purpose, has commenced at a later time to use it for the

purpose of gaining or producing income therefrom, or for the purpose of gaining or producing income from a business, he shall be deemed to have acquired it at that later time at its fair market value at that time.

Paragraph (a) deals with depreciable assets which are converted to personal use or some other non-business purpose. In such a case the asset class is credited with the fair market value of the asset. Similarly, in paragraph (b), where the taxpayer brings personal assets into a business, the asset class is debited with the fair market value of the asset.

What, however, do we allocate to the accounts when there is a conversion from capital to inventory or vice versa. The tax authorities, at present, by allowing capital cost allowance on assets which could otherwise be inventory, are operating in a rather ad hoc fashion and, sooner or later, as pointed out by H. Heward Stikeman, 25/and Marshal A. Cohen, 26/ the problem will be squarely before the courts unless provision is made in the Act to clarify the situation.

The question of conversion has arisen on several occasions in both the United Kingdom and Indian courts. In Watson Bros. v. Hornby, 27/ the taxpayers operated a chick hatchery, offering for sale "day old chicks", and also carried on the business of poultry breeders and dealers. From time to time, they transferred chicks from their hatchery to their farm, and the question was whether to credit the hatchery business with the going market rate per chick or with the cost of producing the chicks, which was greater in this case. The court found that the amount to be credited was the "reasonable price", or fair market value of the chicks. In effect, the court held that inventory losses must be taken into account when stock-in-trade is transferred from one operation of the taxpayer to another.

This case was followed by the celebrated case of Sharkey v. Wernher (cited above), which dealt with a taxpayer who raised horses for sale and who also maintained a stable of race horses as a personal hobby. When five horses were transferred from the farm to the stable, that is, from inventory to personal capital, it became necessary to determine how much should be credited to the farm operations. The House of Lords found that fair market value should be used.

The Supreme Court of India, in Commissioner of Income-tax v. Kooka, 28/ had to deal with the problem of the conversion of capital assets into inventory. The taxpayer had held for investment purposes a large number of shares in various companies. These were considered to be bona fide investments until the 1945-46 taxation year, when the taxpayer became an active trader, converting, in effect, her investments into stock-in-trade. The question was whether to use original cost or fair market value as the cost of goods to be sold. The Supreme Court of India held that the profits should be computed according to ordinary commercial principles, which necessitated the use of market value as of the date on which the shares were converted into stock-in-trade.

Closer to home, we can witness the confused manner in which the Tax Appeal Board has grappled with this problem of conversion. In C. Bar C. Ranch Ltd. v. M.N.R., 29/ the taxpayer company had purchased certain farm property for purposes of farming and ranching. When these objects became uneconomic it was decided to subdivide the lands; in the result there was a conversion from capital into inventory. The Board acknowledged that the farm was once capital but completely ignored the problem of conversion and thereby required that the taxpayer bring the land into inventory at cost.

One would have thought that the taxpayer would have been able to value the inventory at market at the time of conversion under section 14(2). However, this was refused.

In Reade v. M.N.R., 30/ the Board, in considering the problem of converting land as a capital asset into inventory, distinguished the Sharkey v. Wernher case by indicating that the Sharkey case dealt with horses and the instant matter concerned land.

Alternatives

It seems, therefore, that we should come to grips with this problem of Sharkey v. Wernher, and more especially with the general problem of conversion. Where the Income Tax Act has dealt, although sparingly, with the problem, that is, section 20(6)(a) and (b), the basis for valuation has been fair market value. The jurisprudence in the United Kingdom has also indicated that fair market value should be applied in the case of conversion.

If the Income Tax Act were to deem that conversions from capital into inventory or from inventory into capital take place at fair market value what would be its effects?

1. Where inventory is converted into capital, assuming that market exceeds cost, there will be a notional profit; however, if what is converted became depreciable assets, the taxpayer will have a stepped-up base for capital cost allowance. Conversely, if market is less than cost, an inventory loss will result.

2. Where capital assets are converted into inventory, recapture is quite likely, with a five-year spreadback; however, the profit on the sale of the inventory will be minimized.

Generally speaking, hardship will not result if these conversions are based on fair market value. More important, however, such deeming provisions will clear the murky waters which surround the subject of conversion.

REFERENCES

- 1/ The Income Tax Act, R.S.C. 1952, Chapter 148.
- 2/ L. J. Harris v. M.N.R., 63 DTC 160 (TAB); 31 Tax A.B.C. (1963) 113; affirmed, 64 DTC 5332 (Ex. Ct.); [1964] C.T.C. 562.
- 3/ Harold E. Crate, "Sale and Lease Back Arrangements", Corporate Management Conference, V. 15, Toronto: Canadian Tax Foundation, June 1959, pp. 94-95.
- 4/ Joint Committee Representing The Canadian Bar Association and The Canadian Institute of Chartered Accountants, Recommendations for Amendments to The Income Tax Act and The Estate Tax Act, December 1962, pp. 30-32.
- 5/ H. T. Benton v. Comm'r., 197 F. 2d 745 (5th Cir. 1952), where the terminal payment under the option was 41% of the total paid under the lease plus the option. Accord. Western Contracting Corp., 59-2 USTC Par. 9751 (8th Cir.); H. H. Tomlinson, 60-2 USTC Par. 9578 (D.O.).
- 6/ Holeproof Hosiery Co. v. Comm'r., 11 BTA 547 (1928). Accord. Judson Mills, 11 T.C. 25 (1948); Marvin Berry, 11 TCM 301.
- 7/ Ibid., at p. 556.
- 8/ L. J. Harris v. M.N.R., 63 DTC 160 (TAB); 31 Tax A.B.C. (1963) 113; affirmed, 64 DTC 5332 (Ex.Ct.); [1964] C.T.C. 562.
- 9/ G.S.A. Wheatcroft, The Law of Income Tax, Surtax and Profits Tax, Sweet and Maxwell, London, 1962.
- 10/ Classes 19 and 21 permit a 50% rate of capital cost allowance for certain machinery and equipment which is used in manufacturing and processing.

Class 22 permits a 50% rate of capital cost allowance for power-operated movable equipment designed for the purpose of excavating, moving, placing or compacting earth, rock, concrete or asphalt.

Class 10 permits a 30% rate of capital cost allowance on all automotive equipment.
- 11/ It was acknowledged by those interviewed that legislation which is designed to characterize a transaction as being something which it is not leads to many hidden pitfalls—to wit, former section 18.
- 12/ In order to avoid the provisions of section 8(1) (appropriation of property to shareholders), the vendor in this illustration would have to be the parent company.

- 13/ Joint Committee Representing The Canadian Bar Association and The Canadian Institute of Chartered Accountants, Recommendations for Amendments to The Income Tax Act and The Estate Tax Act, C.I.C.A., Toronto, December 1962, pp. 10-11; Canadian Tax Foundation, Toronto, December 1962, pp. 10-11; Canadian Bar Journal, Vol. 6, No. 1, February 1963, pp. 14-15.
- 14/ Joint Committee Representing The Canadian Bar Association and The Canadian Institute of Chartered Accountants, Recommendations for Amendments to The Income Tax Act and The Estate Tax Act, C.I.C.A., Toronto, December 1962, p. 10; Canadian Tax Foundation, Toronto, December 1962, p. 10; Canadian Bar Journal, Vol. 6, No. 1, February 1963, p. 14.
- 15/ L. T. Smith, "Twelve Years of Capital Cost Allowances", Corporate Management Conference, Toronto: Canadian Tax Foundation, 1961, p. 22.
- 16/ Chess v. M.N.R., 63 DTC 404; 32 Tax A.B.C. (1963) 48. Marsh v. M.N.R., 63 DTC 650; 32 Tax A.B.C. (1963) 429.
- 17/ Steen Realty Ltd. v. M.N.R., (Ex. Ct.), 64 DTC 5081; [1964] C.T.C. 133; affirming 60 DTC 531; 25 Tax A.B.C. (1960) 161.
- 18/ In Stein v. M.N.R., 64 DTC 252; 35 Tax A.B.C. (1964) 143; the Tax Appeal Board adopted the approach expressed in the Steen Realty case.
- 19/ Touzeau v. M.N.R., 63 DTC 1 (TAB); 30 Tax A.B.C. (1962-63) 301.
- 20/ G.H.C. Investments Ltd. v. M.N.R., 61 DTC 1120 (Ex. Ct.); [1961] C.T.C. 187.
- 21/ Joint Committee Representing The Canadian Bar Association and The Canadian Institute of Chartered Accountants, Recommendations for Amendments to The Income Tax Act and The Estate Tax Act, C.I.C.A., Toronto, December 1962, p. 14; Canadian Tax Foundation, December 1962, p. 14; Canadian Bar Journal, Vol. 6, No. 1, February 1963, p. 22.
- 22/ Ibid., pp. 13-14.
- 23/ The basis for recapture is that the taxpayer has taken capital cost allowance in excess of the real declining value of the asset.
- 24/ Sharkey v. Wernher, [1956] A.C. 58.
- 25/ Canada Tax Service, Vol. A, p. 4-150B.
- 26/ "Constructive Profits under the Income Tax Act", Canadian Tax Journal, 1963, Vol. XI, No. 2.
- 27/ Watson Bros. v. Hornby, (1942) 24 T.C. 506.
- 28/ Commissioner of Income-tax v. Kooka, (1962), 46 I.T.R. 86.
- 29/ C Bar C Ranch Limited v. M.N.R., 63 DTC 872; 33 Tax A.B.C. (1963) 345.
- 30/ Reade v. M.N.R., 64 DTC 99; 34 Tax A.B.C. (1963-64) 313.

CHAPTER 6—TAX DEPRECIATION IN
SELECTED FOREIGN COUNTRIES

DEPRECIATION IN THE UNITED STATES

Introduction

Depreciation rules in the United States were substantially changed in 1962. 1/ For this reason it is advisable to view the U. S. system in two parts: the rules as they existed prior to the Revenue Act of 1962, followed by the changes, either accomplished or intended, under the amending legislation. This treatment of the subject necessarily includes an examination of the defects inherent under the prior system. The changes have been enacted too recently to judge their success or failure, but some predictions can be made as to their efficacy.

Depreciation Under 1954 Code

Statutory Authority For
Depreciation Allowances

The statutory authority permitting a deduction for depreciation (including obsolescence) is found in the Code 2/ section 167, which reads, "There shall be allowed as a depreciation deduction a reasonable allowance for exhaustion, wear and tear (including a reasonable allowance for obsolescence)...."

The language used indicates that a taxpayer is entitled as of right to a deduction for depreciation 3/ but the deduction taken must be "reasonable". The section also provides a tentative definition of "depreciation", by limiting it to "exhaustion, wear and tear [and] ...obsolescence...."

Accounting Methods Allowed

The methods allowed for calculating depreciation are, in part, set out in the statute itself. It reads:

...the term "reasonable allowance"...shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary...under any of the following methods:

- (1) the straight-line method,
- (2) the declining balance method...4/
- (3) the sum of the years-digits method 5/ and
- (4) any other consistent method 6/.... 7/

Thus, the Code itself allows great flexibility in permissible accounting methods. However, there is one limitation which must be borne in mind. Depreciation allowances may not exceed the cost of the asset less its salvage value. No matter which accounting method is used, the taxpayer may not depreciate an asset below its acknowledged salvage value. 8/

For example, a taxpayer purchases a piece of equipment at a cost of \$2,100. It has an estimated useful life of ten years, and at the end of that time it is expected to have a resale or salvage value of \$100. Regardless of the accounting method employed, this equipment may not be depreciated below \$100. Neither straight-line, declining balance, nor sum of the years-digits method of depreciation will bring the balance to zero. In this example, the total depreciation that may be taken, by whatever method, may not exceed \$2,000.

Bittker, 9/ in the following table, compares the allowances for depreciation under the three statutory methods. As in the example given above, the table is based upon equipment having an estimated useful life of ten years, a cost of \$2,100, and an estimated salvage value at the end of its useful life of \$100.

<u>Year</u>	<u>Annual Depreciation</u>		
	<u>Straight-line (10 per cent)</u>	<u>20 per cent Declining Balance</u>	<u>Sum of the Years-Digits</u>
1.....	\$ 200	420.00	363.64
2.....	200	336.00	327.27
3.....	200	268.80	290.90
4.....	200	215.04	254.54
5.....	200	172.03	218.18
6.....	200	137.63	181.82
7.....	200	110.10	145.45
8.....	200	88.08	109.09
9.....	200	70.46	72.74
10.....	200	56.37	36.37
Total.....	<u>\$2,000</u>	<u>1,874.51</u>	<u>2,000.00</u>
Salvage value or unrecovered cost	\$ 100	225.49*	100.00

* Observe that the salvage value is not taken into consideration in computing a declining balance rate, but it must be recognized and accounted for when the asset is retired.

It will be noted that the Code does not confine the taxpayer to the three methods of computing depreciation specifically enumerated, 10/ but rather it expressly permits "any other consistent method". 11/ Other methods recognized by the Commissioner include the following:

Unit of Production Method

This method is generally favoured in determining depreciation for property used in the exploitation of natural resources, such as mineral deposits or timber, the available reserves of which limit the useful

life of the depreciable property. The rate of exhaustion of the natural resource measures the useful life of the physical property. By dividing the cost or other basis, less estimate salvage value, by the estimated available reserves of raw material, a unit cost is obtained which, when multiplied by the units produced during a given year, gives the depreciation sustained for that year.

Retirement Accounting

In this method of accounting for depreciable property, the cost of property retired each year is credited to the capital asset account and, less net salvage, charged to expense in lieu of annual provisions for depreciation. The retirement method is largely restricted to railroads, where it has long been sanctioned by regulatory bodies in fixing rates.

Other Rules Affecting Depreciation Allowances

Rate of Depreciation Based on Useful Life of Asset

In the United States, an asset's expected useful life is legally determined, not from tables or classes established in the statute or by Regulation, but as a question of fact for each asset depreciated. It is interesting to note, however, that the Internal Revenue Service had published a bulletin (known as Bulletin "F") containing an apparently inexhaustible list of assets, 12/ each with a recommended useful life. Thus, a blanket had a useful life of six years, a delivery truck, five years, an ice cream can, four years, a lathe, 30 years. But it cannot be emphasized too strongly that these useful lives were a guide only. The tax assessor would pass

without objection the useful life which conformed with the guideline; but the taxpayer could always argue for a shorter life and a more generous depreciation allowance.

As depreciation is based essentially on an asset's useful life, some criteria had to be established. The Regulation dealing with the question was as follows:

Useful life. For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. 13/

For example, a building used in trade or business may be expected to have a useful life of 45 years (office buildings under Bulletin "F" have a useful life of 45 years). The often unknown factor is obsolescence. In computing expected useful life, the taxpayer is entitled to consider both the useful physical life of the asset plus predictable obsolescence. In a 1947 decision, the Tax Court permitted the owner of a building in Times Square, New York City, to depreciate the building over a period of 21 years, even though its physical life would be much longer, "We think it reasonable under the evidence to determine that, within a period of 21 years...the present building will be removed and a much taller one erected that will produce revenue more in keeping with the value of the lot." 14/

Grouping of Assets

Although the taxpayer is permitted to depreciate each asset separately, he is not obliged to do so. The Regulations permit him to employ group, classified or composite accounting, where a number of assets with the same or different useful lives are combined into one account. He then uses a single rate of depreciation for the entire group.

Group Accounts. Group accounts are accounts containing assets which are similar in kind and which have approximately the same estimated useful lives. The group rate is determined from the average of the useful lives of the assets. Thus, where three assets are grouped together and Asset A has a useful life of four years, Asset B a useful life of five years, and Asset C a useful life of six years, the group will have a useful life of five years and will be depreciated at 20 per cent.

Classified or Composite Accounts. In the case of classified or composite accounts, the rate is generally computed by determining the amount of one year's depreciation for each item or each group of similar items, and by dividing the total depreciation thus obtained by the total cost or other basis of the assets. The average rate so obtained is used as long as subsequent additions, retirements, or replacements do not substantially alter the relative proportions of different types of assets in the account. An example of the computation of a classified or composite rate follows:

<u>Cost or Other Basis</u>	<u>Estimated Useful Life</u>	<u>Annual Depreciation</u>
	<u>Years</u>	<u>Straight-Line</u>
\$ 10,000	5	\$ 2,000
<u>10,000</u>	15	<u>667</u>
\$ 20,000		\$ 2,667

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The average rate is 13.33%, unadjusted for salvage. Assuming the estimated salvage value is 10% of cost (or basis), the rate adjusted for salvage will be 13.33% minus 10% of 13.33%, which works out to 12%.

By following this procedure, a widely dissimilar group of assets can be listed in one account for depreciation purposes. Once the rate has been established, as it was established above, new assets can be added to the group, while other assets can be retired. The depreciation is still based upon the rate established for the group, provided always that the additions do not change the composition of the group sufficiently to require a change in rate. The following example is contained in the Regulations:

The use of the straight line method for group, classified, or composite accounts is illustrated by the following example: A taxpayer filing his returns on a calendar year basis maintains an asset account for which a group rate of 20 percent has been determined, before adjustment for salvage. Estimated salvage is determined to be $6\frac{2}{3}$ percent, resulting in an adjusted rate of 18.67 percent. During the years illustrated, the initial investment, additions, retirements, and salvage recoveries, which were determined not to change the composition of the group sufficiently to require a change in rate, were assumed to have been made as follows:

- 1954 — Initial investment of \$12,000.
- 1957 — Retirement \$2,000, salvage realized \$200.
- 1958 — Retirement \$2,000, salvage realized \$200.
- 1959 — Retirement \$4,000, salvage realized \$400.
- 1959 — Additions \$10,000.
- 1960 — Retirement \$2,000, no salvage realized.
- 1961 — Retirement \$2,000, no salvage realized.

Depreciable Asset Account and Depreciation Computation on Average Balances							
Year	Asset Balance Jan. 1	Current Additions	Current Retire- ments	Asset Balance Dec. 31	Average Balance	Rate (Per cent)	Allowable Depre- ciation
1954	-	12,000	-	12,000	6,000	18.67	1,120
1955	12,000	-	-	12,000	12,000	18.67	2,240
1956	12,000	-	-	12,000	12,000	18.67	2,240
1957	12,000	-	2,000	10,000	11,000	18.67	2,054
1958	10,000	-	2,000	8,000	9,000	18.67	1,680
1959	8,000	10,000	4,000	14,000	11,000	18.67	2,054
1960	14,000	-	2,000	12,000	13,000	18.67	2,427
1961	12,000	-	2,000	10,000	11,000	18.67	2,054*

Year	Depre- ciation Reserve Jan. 1	Corresponding Depreciation Reserve Account			Depre- ciation Reserve Dec. 31
		Depre- ciation Allowable	Current Retire- ments	Salvage Realized	
1954	-	1,120	-	-	1,120
1955	1,120	2,240	-	-	3,360
1956	3,360	2,240	-	-	5,600
1957	5,600	2,054	2,000	200	5,854
1958	5,854	1,680	2,000	200	5,734
1959	5,734	2,054	4,000	400	4,188
1960	4,188	2,427	2,000	-	4,615
1961	4,615	2,054	2,000	-	4,669

* Section 1.167 (b)-1 (b), Example (3).

The classified or composite group is of interest, because it permits the taxpayer to decide which assets will be placed in the group. There is no requirement that the assets be similar in kind, or that they have useful lives that are approximately the same. Thus, an automobile, a factory building, a pump and a steel filing cabinet could all be placed in the same group, to be depreciated at a single composite rate. This, of course, would permit a business to group most of its assets together and establish a single rate for depreciation purposes.

On the other hand, a taxpayer may establish separate depreciation accounts, maintained by year of acquisition. These assets are then grouped together and depreciated at a rate fixed for the group by either of the methods described above.

Once the account has been selected, the method decided upon must be consistently applied to that particular account thereafter. But note that the same method need not necessarily be applied to acquisitions of similar property in the same or subsequent years, provided such acquisitions are set up in separate accounts.

Any change in the method of computing the depreciation allowances with respect to a particular group would amount to a change in the method of accounting, which is not permitted without the consent of the Commissioner. He will not give his permission unless the change affects all the assets contained in a particular group or account. Note, however, that the Commissioner prefers straight-line depreciation and will permit a change from declining balance to straight-line without consent, providing the change relates to all the assets included in the particular account.

Changes can also be made in the estimated useful life of an asset. If the declining balance method is used, when a change is justified in the useful life estimated for an account, subsequent computations must be made as though the revised useful life had been estimated originally. For example, assume that an account has an estimated useful life of ten years and that a declining balance rate of 20% is applicable. If, at the end of the sixth year, it is determined that the remaining useful life of the account is six years, computations shall be made as though the estimated useful life was originally determined as twelve years. Accordingly, the applicable depreciation rate will be $16\frac{2}{3}\%$. This rate is thereafter applied to the unrecovered cost or other basis. 15/

Postponing Depreciation

A taxpayer is not permitted to postpone or accumulate depreciation, and he will not be permitted to take advantage in later years of his prior failure to claim a depreciation deduction, or of his action in taking deductions plainly inadequate under the known facts in prior years. 16/ Upon the sale or final disposition of an asset, the taxpayer is obliged, before he estimates his gain or loss on disposition, to reduce his cost by

any depreciation that was "allowable" in prior years, whether he took it or not. 17/

Depreciation Period

In the United States, the period of depreciation for an asset does not begin until the asset is placed in service. It ends when the asset is withdrawn from service. As a matter of practice, time is computed to the nearest month. Thus, an asset placed in service on the 13th of August will receive five months' depreciation in the year of purchase, i.e., 5/12 of the annual allowance. If the asset were placed in service on the 17th of August, only four months' depreciation would be allowed for that year. A proportional part of one year's depreciation is also allowable for that part of the last year during which the asset is in service.

In the case of a multiple asset account, the amount of depreciation may be determined by using what is commonly described as an "averaging convention", that is, by using an assumed timing of additions and retirements. For example, it might be assumed that all additions and retirements to the asset account occur uniformly throughout the taxable year, in which case depreciation is computed on the average of the beginning and ending balances of the asset account for the taxable year. Still other averaging conventions may be used, including the one under which it is assumed that all additions and retirements during the first half of a given year were made on the first day of the year and that all additions and retirements during the second half of the year were made on the first day of the following year. Thus, a full year's depreciation would be taken on additions in the first half of the year and no depreciation would be taken on additions in the second half. Moreover, under this convention, no depreciation would be taken on retirements

in the first half of the year and a full year's depreciation would be taken on the retirements in the second half. An averaging convention, if used, must be consistently followed in the account or accounts for which it is adopted, and must be applied to both additions and retirements. In any year in which an averaging convention substantially distorts the depreciation allowance for the taxable year, it may not be used. 18/

The fact that an asset must be placed in service before depreciation is allowed is significant. It is not enough that a machine be purchased or a building or factory be under construction. The depreciable property must be "in service" before any depreciation allowance may be claimed for the year in question.

Gain or Loss on Disposition

As in Canada, depreciation deductions are applied against the taxpayer's ordinary income. However, the profit on the sale of an asset, under the 1954 Code, resulted in a capital gain. Similarly, a loss resulted in a capital loss.

Thus, if the equipment used in the example on page 181 supra, was sold at the end of the first year for \$1,950, the result would be as follows:

	<u>Straight Line</u>	<u>20% Declining Balance</u>	<u>Sum of the Years-Digits</u>
Sale price	\$ 1,950	1,950	1,950.00
Adjusted basis	<u>1,900</u>	<u>1,680</u>	<u>1,736.36</u>
Gain on sale	\$ <u>50</u>	<u>270</u>	<u>213.64</u>

The important point to keep in mind is that in each case the gain was treated as a capital gain, taxable at a maximum rate of 25%. As a result of this

provision, excess depreciation claimed and allowed never came back into ordinary income, to be taxed at ordinary rates. To further confound the situation, and increase the economic advantage to the taxpayer who over-depreciated his assets, a loss on the sale of a depreciable asset resulted in a capital loss. In the case of a corporation, such losses could be allowed for tax purposes only to the extent that the corporation had realized a capital gain. 19/ Thus, if the equipment in the example given above sold for only \$1,500 at the end of the first year, a corporate taxpayer would sustain a capital loss of \$400, \$180, or \$236.36, depending on the depreciation method used. If there were no offsetting capital gains, the loss would not be available to reduce income tax liability in the year in question.

Disadvantages Inherent in United States System Under 1954 Code

An examination of the United States system reveals the following obvious defects:

- (a) The transformation of ordinary income into capital gain placed an extraordinary premium on over-depreciation. Similarly, the conversion of an operating loss into a capital loss placed a heavy penalty on the taxpayer who failed to take adequate depreciation. Thus the system generated the strangest incentive to over-depreciate.
- (b) The system afforded far too many opportunities to over-depreciate. There were two basic questions of fact which the taxpayer could always argue:
 - (i) an asset's useful life, and
 - (ii) its salvage value at the end of its useful life.

The effect of these two variables on the allowable depreciation in any one year can be illustrated in the following example.

In 1958 a taxpayer purchases an asset for \$10,000. He knows that it will have a useful life of ten years and he will be able to sell it for \$3,000. Using the straight-line method, the annual allowance for depreciation should be \$700. But if the Revenue Service can be persuaded that the useful life is only six years and the salvage value is \$400, the annual allowance for depreciation becomes \$1,600.

The problem is really more complex than appears from this example where there is a certain element of dishonesty on the part of the taxpayer. Take the case of an automobile purchased new (by a Re Drive company at factory prices) for \$1,650. The taxpayer claims an economic life of four years and assumes no salvage value at the end of that time. The depreciation allowances are based upon the assumption that the taxpayer will keep the car and use it as a Re Drive or rental vehicle for the full four years. At the end of the four years it must be written off. Now, even if the economic life of the vehicle is four years, this particular taxpayer never keeps a car for that length of time. In his business he must have a current model in good condition. He sells his cars, on an average, for \$1,380, after only 15 months' use. Thus, the whole basis upon which he calculates his depreciation is distorted, with the following results:

Cost price	\$ 1,650
Depreciation (straight-line for 15 months)	515
Basis	1,135
Sale price	<u>1,380</u>
Capital gain	<u>\$ 245</u>

Multiply this situation by 140 cars in a fleet and the taxpayer has succeeded in converting \$34,300 from ordinary income into a capital gain.

The facts given above are those found in Commer v. Evans, 364 U.S. 92 (1960). There, the taxpayer strenuously argued that the useful life was the total physical or economic life of the automobile, not just the period for which it would be used in the taxpayer's business. In other words, the taxpayer argued that a method of depreciation which permitted him to convert income into capital should be continued, even though the facts upon which the calculation was based were clearly erroneous. The Court quite rightly held:

1. that the taxpayer should recover in total depreciation allowances only the cost of the asset less its resale or salvage value,
2. that the useful life of the asset must be related to the period it may be employed in the business of the particular taxpayer, and
3. salvage value must include the resale value at the time the taxpayer intends to sell the asset.

Clearly, any other decision on the part of the Supreme Court would have been erroneous. But we must not lose sight of a fact which is of paramount importance: it was the tax legislation itself that bred the litigation. It is a highly complex system abounding with questions of fact which are bound to be contentious considering the effect these questions have on the depreciation allowance, and the premium placed upon over-depreciation. The failure to provide for recapture simply accentuates the problem.

Administratively, it must be an endless chore trying to decide if each and every taxpayer has chosen the correct useful life, not only for the type

of asset he owns, but also for the use he makes of that asset. In an effort to limit the endless haggling which could take place, the Code was amended in 1954 to permit the taxpayer and the Internal Revenue Service to enter into written agreements concerning useful life and rate of depreciation of any property. 20/ So long as the facts remain the same, the rate agreed upon binds both the taxpayer and the Secretary.

The 1962 Amendments

Revenue Act of 1962

As might have been expected, the most important change was to introduce a recapture provision. 21/ However, the section provides only for limited recapture, as it does not apply to all depreciable property.

Under the new law, there is a recapture of depreciation on the sale of the following:

- (a) personal property, 22/ or,
- (b) other tangible property which is used as an integral part of certain manufacturing, production and extraction activities. 23/

Excluded from the recapture provisions is depreciable property:

- (a) which is not an integral part of manufacturing, production and extraction activities, 24/
- (b) livestock, and
- (c) buildings.

It should be noted that not every disposition of property subject to recapture results in recapture at the time the taxpayer claiming the

depreciation disposes of the property. If the depreciable property is transferred by gift or on death, there is no recapture until the donee or beneficiary sells the asset. He then takes his predecessor's basis, and pays the appropriate tax on the recaptured depreciation.

Revenue Procedure 62-21

The second major change in 1962 was administrative rather than legislative. On July 11th the Treasury issued new "Depreciation Guidelines and Rules", in the form of a Treasury Release. This superseded Bulletin "F" referred to supra at page 182.

It is not a simple task to explain to those trained in Canadian depreciation rules either the significance or the legal impact of the change in "useful life" guidelines. Neither Rev. Proc. 62-21, nor its predecessor Bulletin "F", are statutory or quasi-statutory. Neither appear in the Code or in the Regulations made thereunder. They are simply administrative guides used by tax officials in assessing returns. They are a yardstick used to test claims for depreciation made by individual taxpayers. It might be more accurate to say that they simply test the "reasonableness" of the claim for depreciation. If the allowance claimed is within certain limits acceptable under the various tables published with the Treasury Release, then the resulting depreciation allowance will not be questioned. But if the allowance claimed does not meet the "Reserve Ratio Test" embodied in the Procedure, then the allowance claimed will be challenged and the taxpayer must prove his case.

Part I of the Guidelines provides accepted useful lives for a large number of assets and industries. They are divided into four groups:

Group One	Depreciable assets used by business in general
Group Two	Non-manufacturing activities, excluding transportation, communications and public utilities
Group Three	Manufacturing
Group Four	Transportation, communications and public utilities.

The interesting feature of this arrangement is that, with the exception of Group One, the grouping relates to industries rather than to things. A single guideline class includes all depreciable property that is not covered by any other guideline class (i.e., Group One, office furniture and equipment; transportation equipment such as automobiles, trucks, railroad cars and vessels; land improvements; and buildings). The industry guideline class includes production machinery and equipment; special jigs, dies, molds and similar equipment; power plant machinery and equipment; special equipment; and special-purpose structures used in that industry, but not, as stated above, depreciable assets used by business in general.

Thus, in the hotel industry, the old Bulletin "F" listed 18 separate specified lives for equipment used in hotels, ranging from six years for blankets to 20 years for fire alarms and prevention equipment. Under the new Procedure, hotel equipment is found in a single guideline class for Service Industries, set at 10 years.

For ice-cream producers, Bulletin "F" provided 111 items ranging from ice-cream cans (four years) to cast iron flavouring kettles (25 years). The new Procedure groups ice-cream producers into a guideline class for Food Products, with an approved useful life of 12 years.

Soap producers formerly grouped their depreciable assets into 201 item lives, ranging from four years for fat acid pumps to 30 years for lathes used

in making barrels. Under the new Procedure, soap manufacturers are covered by the 11-year guideline life for all machinery and equipment used in the chemical and allied industries.

Thus, the air transport industry has a guideline life of six years, pulp and paper manufacturers, 16 years, aerospace industry, eight years, sugar and sugar products producers, 18 years, and so on.

The guideline life is only part of the story, however. It is but one of three factors introduced into what is known as the Reserve Ratio Test.

Reserve Ratio Test

This is what the Procedure describes as an "objective standard" against which can be measured the "appropriateness" of the depreciation allowance claimed by the taxpayer. This test measures the relationship between tax lives (i.e., expected useful lives) and the actual replacement practice of each individual taxpayer. It may be used by the taxpayer as a means of "automatically" justifying his right to the depreciation allowances he has claimed.

The reserve ratio test is computed as follows:

1. The reserve ratio is determined by dividing the depreciation reserve for a particular class of assets by the original cost or other basis of these assets.
2. The rate of growth of the guideline class is ascertained by first computing the ratio of assets in the class at the close of the current year to the assets in the class at the close of a "base year"—where possible, an earlier entire replacement cycle. The taxpayer can then read his rate of growth from the table provided in the Procedure.

3. The class life to be tested is then found.

4. The taxpayer's reserve ratio is then compared with the reserve ratio range selected from the Reserve Ratio Table which is appropriate to the method of depreciation being used for the assets in that class, the rate of growth in the class, and the test life for that class.

Here is an example of how a taxpayer using straight-line depreciation and a 10-year class life would compute—and find that he met—the reserve ratio test:

Cost of assets in guideline class	\$10,000
Depreciation reserve	5,200
Reserve ratio, therefore, is	52%
Assets one replacement cycle earlier	\$ 8,200
Ratio of present assets to base-year assets	1.129
Rate of growth (from Growth Table)	2%
Annual test life used	10
Appropriate reserve ratio range (from Reserve Ratio Table)	44-56%

According to the Treasury Release, an important feature of the reserve ratio test is the latitude it allows taxpayers in the determination of their depreciable lives, provided only that they meet "reasonable standards".

As an interim measure, the Internal Revenue Service will allow all taxpayers to use useful lives at least as generous as those published in the Procedure. Use of the guideline life is allowed "automatically...to all taxpayers at the outset". The Service will continue to accept the resulting depreciation allowances for a three-year transitional period. Only after the expiration of this three-year period will the test come into play. If the test then provides "clear indications that the taxpayer's

replacement practices do not conform with the depreciation claimed" the service will demand a longer useful life and less depreciation. Thus, for each taxpayer, the system is intended to provide a built-in corrector, which is illustrated in the following example:

A taxpayer who has been using a 12-year class life and who is unable to demonstrate that the facts and circumstances of his case justify use of that life would have the life lengthened in the following situation:

<u>Method of Depreciation</u>	<u>Double Declining Balance</u>
Cost of assets in guideline class	\$10,000
Depreciation reserve for class	6,500
Reserve ratio, therefore, is	65%
Rate of growth	4%
Annual life being tested	12
Appropriate reserve ratio range (from Reserve Ratio Table)	53-61%
Annual life to which he would be lengthened (from Adjustment Table)	15

Any necessary lengthening of depreciable lives will be put into effect no earlier than the first year in which the reserve ratio test is not met and the life cannot be justified on the basis of the facts and circumstances. The lives will not be lengthened for any earlier taxable year.

Conclusion

The United States depreciation rules theoretically allow for the individual differences inherent in the business practices of individual taxpayers. The new rules provide a highly complex system which checks mathematically on the actual replacement policy of each corporation or proprietorship.

In this respect, it has none of the absolute rigidity found in the Canadian system. Nevertheless, Rev. Proc. 62-21 may prove to be almost as administratively cumbersome as its predecessor, Bulletin "F". The extreme latitude given by the Statute, as to depreciation method, where "reasonable" depreciation is always a question of fact, must necessarily continue as a breeding ground for contention and, it follows, for litigation.

Nevertheless, the industry approach, rather than the individual asset approach, may contribute substantially to simplification in accounting procedures. If the Reserve Ratio Test is upheld by the courts, corporations sustaining extraordinary depreciation will be fairly dealt with, while the taxpayer taking excessive depreciation (even though the rate used is allowable under the blanket class or useful life designation) will be cut back to a more realistic allowance.

It may be that the same thing could be done in Canada, in a less sophisticated and complex way, by applying the loss on sale or disposition directly to the current revenue or expense account. If this is not feasible, then the Reserve Ratio Test may be worthy of a more detailed study, either as a check on actual performance, or as a basis for allowing accelerated depreciation to individual taxpayers.

DEPRECIATION IN THE UNITED KINGDOM

Depreciable Assets

The capital assets eligible for annual depreciation allowances under the United Kingdom Acts come under the following general classes.

Industrial Buildings and Structures

Generally speaking, industrial buildings are those used in industries of a productive, as opposed to a distributive nature. Depreciation allowances are, thus, generally confined to buildings used in the manufacturing, processing and extractive industries (including buildings for storing manufactured, processed or imported goods and materials), and in transport, water, power, fishing and agricultural undertakings.

It should be noted that the statutory definition of eligible structures explicitly excludes those used as a dwelling, retail shop, showroom, hotel, office or ancillary purpose; hence, buildings used for commercial or service enterprises, rental houses, apartment buildings, etc., are excluded. The 1951 report of the Tucker Committee (Committee on the Taxation of Trading Profits, page 68) contained a recommendation for the granting of annual depreciation allowances in respect of commercial buildings, but despite the endorsement of this proposal by the United Kingdom Royal Commission (Final Report, page 118), no action has been taken.

An industrial building or structure may be depreciated by (a) the person who has incurred capital expenditure 25/ in its construction or for capital repairs thereto, and by (b) his successor in interest, provided that the property is used by him, his lessee or sub-lessee for business purposes.

Where part of a structure qualifies as an industrial structure and part does not, then if the capital expenditure on the construction of the latter is one tenth or less of the total capital expenditure on the structure, the whole structure is treated as an industrial structure.

Machinery and Equipment

Annual depreciation allowances are granted for capital expenditure (including demolition expenditure) on machinery and plant for the purposes of a trade, a profession or vocation, an office or employment, etc. (i.e., for purposes of the business). "Machinery" and "plant" are not defined by statute, except that they include installation costs and the cost of alteration of an existing building incidental to such installation. It has been held that plant "...in its ordinary sense includes whatever apparatus is used by a business man for carrying on his business—not his stock-in-trade which he buys or makes for sale; but all goods and chattels, fixed or movable, live or dead, which he keeps for permanent employment in his business". ^{26/} It has since been held that movable office partitioning was plant. ^{27/} Machinery and plant are conceded by the Revenue in a published leaflet to include fixtures and fittings of a permanent and durable nature. Expenditure on a private car is limited to £2,000 for purposes of the annual allowance.

As with industrial buildings, machinery and equipment are eligible for depreciation only if they are in use at the end of the basis period for the particular tax year.

The person entitled to an annual allowance is normally the person who owns and is using the machinery and plant for the appropriate purpose. Where machinery and plant are leased, the person entitled to annual depreciation is the one who bears the burden of wear and tear: this can be either the lessor or the lessee, but if the former, he must be in the leasing business.

Mines, Oil Wells and Other
Wasting Mineral Assets

Annual depreciation allowances are granted to a person whose trade consists either wholly or in part of the working of a wasting mineral deposit. The allowances are given for two classes of expenditure:

- (a) on searching for or on discovering and testing mineral deposits or winning access thereto (an allowance on revenue account is also given for expenditure on abortive exploration);
- (b) on the construction or demolition of any works which are likely to be of little or no value when the source is no longer worked.

A taxpayer is not allowed to depreciate the cost of acquiring mineral rights nor the cost of the site of mineral deposits, unless they are outside the United Kingdom. Allowance is granted for machinery and plant used for prospecting or winning access to mineral deposits, in which case an allowance cannot also be claimed under the machinery and plant group previously discussed.

Scientific Research

Capital expenditure on scientific research 28/ directly undertaken by a person, either while carrying on, or immediately before setting up a trade, and which is related to that trade, qualifies for an annual depreciation allowance to that person. The expenditure is related to the trade if it leads to, or facilitates, an extension of the trade or if it is of a medical nature which has a special relation to the welfare of workers employed in that trade. Qualifying scientific research expenditure includes both the cost of buildings (e.g., a laboratory) and the cost of machinery, as well as

the cost of overhead, supplies, salaries, and other such expenditures, which are regarded as capital expenditures.

Patents

With a single exception, no amortization, depreciation or other deduction is allowed in respect of capital expenditure on the acquisition of intangible property or rights of a limited duration, whether or not they are acquired for business purposes. The exception is the purchase of a patent right. Amortization is granted only for patent rights, the income from which would be includible in business profits or would otherwise be liable to income tax. The amount of allowable amortization can only be used to reduce business profits or income from patents, and cannot be applied against income from other sources. The allowance is made to the person incurring the expenditure.

Agricultural and Forestry Buildings and Works

Expenditure incurred for the purposes of husbandry, forestry, on the construction of farmhouses, farm or forestry buildings, cottages, fences or other works on agricultural or forestry land, qualifies for an annual allowance to the person incurring it, provided that he is either the tenant or the owner of the land on which the works are constructed. Where the interest in the land of the person who incurred the expenditure is transferred to another person, the transferee is entitled to the allowance in subsequent years in which he retains the interest. Where the interest is a tenancy which comes to an end, the immediate reversioner is entitled to the allowances after this event, except that an incoming tenant who makes payment to the outgoing tenant for the relevant assets will himself qualify for the allowance.

Depreciation Allowances

There are four types of allowance, but not every type is applicable to each class of expenditure.

Annual Allowance

This is the "normal" depreciation allowance (representing theoretical annual exhaustion) which is granted each year until the cost has been written off or until the asset is disposed of or ceases to qualify. It is the annual allowance which has been referred to in the foregoing enumeration of depreciable assets. The rules governing the annual allowance vary by class of depreciable asset:

Industrial Structures

Industrial structures may be depreciated on the straight-line basis only. The prescribed rate is 2%, but depreciation cannot be claimed beyond the 50th tax year after the structure, or capital repairs thereon, was first used. Hence, if depreciation is not allowable in a particular year (e.g., a factory is not used for industrial purposes that year), the allowance for that year is irretrievably lost. Capital repairs (also limited to 50 years) are depreciated separately from construction costs; hence, depreciation of the former will continue after the latter have been actually or hypothetically written off.

As in Canada, provision is made for recapture or a terminal loss on a sale (the United Kingdom uses the terms "balancing charges" and "balancing allowances": these will be discussed later), and where sale of an industrial structure gives rise to one of these, the depreciable cost to the buyer is

the sale price plus or minus the balancing charge or allowance to the seller. A prospective purchaser would, therefore, be wise to ascertain the seller's depreciated cost and balancing adjustment before the transaction is completed. The purchaser may only depreciate for the remaining portion of the 50 years following the building's first use.

Machinery and Plant

Machinery and equipment may be depreciated on the straight-line basis or by the reducing balance method (there is also a special method applicable to mineral extraction industries). The usual choice is the reducing balance method, since the straight-line method requires separate tax accounting for each asset. In practice, moreover, group depreciation is permitted for assets with comparable useful lives when the reducing balance method is employed, whereas assets are not allowed to be pooled when they are depreciated on the straight-line basis. As in Canada, proceeds on sale are credited to the group account, thus postponing a balancing charge or allowance, but in the United Kingdom the taxpayer may claim a balancing allowance in respect of an asset disposed of, instead of crediting the proceeds to the pool. (He may also elect to apply a balancing charge against the depreciable cost of a replacement asset.)

Unlike the treatment of industrial structures, when the original owner sells machinery and plant, the depreciable cost to the purchaser is the selling price, and except in certain situations, has no reference to the original owner's depreciated cost.

Depreciation rates are generally arrived at by agreement between the Inland Revenue Commissioners and the appropriate trade association, and

current lists of rates so decided are published in a Revenue leaflet. The agreed depreciation rate (which is calculated to write down the original cost to 10% thereof at the end of the asset's normal working life and will, therefore, be different for the two methods) is multiplied by 125% each year before being applied: this represents an arbitrary increase of theoretical depreciation in recognition of the lack of precision in any forecast of normal working life. Increase in rates may be applied for to the Commissioners of Inland Revenue.

As with industrial buildings, hypothetical deductions will reduce recovery through depreciation to less than full actual cost, but whereas such hypothetical deductions usually arise in the case of an industrial building because it was not used for industrial purposes that particular year, they usually arise in the case of machinery and plant because the profits from the trade were not liable to assessment to income tax that year.

Mines, Oil Wells, and Other
Wasting Mineral Assets

The amount of the annual allowance is the greater of (a) 5% of the "residue of expenditure" (defined as the original expenditure less other capital allowances except investment allowances) or (b) the residue of expenditure multiplied by the fraction $\frac{x}{x+y}$, where x = the output from the source in the period and y = the future estimated output from that source. This rule is mitigated to give the taxpayer the benefit of hindsight when a mineral deposit is suddenly and unexpectedly exhausted.

For depreciation purposes, the residue of expenditure of the purchaser must take into account that of the seller when a balancing charge or allowance arises on sale.

Scientific Research

The annual allowance is 60% in the first year and 10% in the four subsequent years.

Patents

The expenditure is written off in equal amounts over 17 years, unless (i) the rights are purchased for a shorter period, in which case the expenditure is written off over that period, or (ii) the rights purchased begin one complete year or more after the rights become effective, when the period is 17 years less the number of complete years elapsed since such commencement (or one year if 17 years have elapsed).

If the patent rights are resold, the new purchaser will be entitled to annual allowances based on the price he paid.

Agricultural and Forestry Buildings and Works

The allowance is 10% of the expenditure for 10 successive years.

Initial Allowance

The initial allowance is a form of accelerated depreciation which allows a greater than normal depreciation charge to be written off in the first year. The allowance is available only to the person who incurred the expenditure (it is not compulsory for the taxpayer to claim it), and is normally granted in the year of assessment for the basis period in which the expenditure is incurred (annual allowances do not commence until the asset is in use). Some assets may qualify even though allowance is given only once in respect of the same building, whereas in the case of machinery and

equipment it is given to each person who buys the asset. Since the sum of the initial and annual allowances cannot exceed 100% of the capital expenditure, the initial allowance causes the annual allowances to be relatively smaller in later years: the reduction in annual allowance is postponed longer under the straight-line method than under the diminishing balance method. Because the initial allowance accelerates the write-off, the taxpayer may find himself subject to a higher surtax rate in later years owing to recaptured depreciation. The initial allowance differs in rate for the various classes of depreciable assets and has fluctuated over the years; see Table 6-1 on page 209.

Investment Allowance

The investment allowance is, in effect, a tax subsidy. Unlike the initial allowance, it does not reduce the depreciable cost of the asset for purposes of claiming and calculating the other allowances and, therefore, the investment allowance does not give rise to recapture or terminal loss on disposal. In order to prevent abuses of the investment allowance, elaborate provision is made for its limitation or withdrawal under certain circumstances. The investment allowance is granted only to the person incurring the capital expenditure, and is granted only if the asset is or will qualify as a depreciable asset and will be used by the person incurring the expenditure or by his lessee or sub-lessee for business purposes. A lessee who incurs a qualifying expenditure is usually entitled to the investment allowance. The investment allowance is limited to expenditure on new assets, and successive Chancellors of the Exchequer have made it clear that it is intended as an economic regulator and will, therefore, be suspended and restored according to the dictates of the public interest: such has indeed

TABLE 6-1
HISTORY OF INITIAL ALLOWANCE

<u>Class of Assets</u>	<u>Years in which Ordered or Acquired (Notes)</u>	<u>Possibility</u>
Buildings		
All buildings	1950-51	A
New factory buildings extending productive capacity	1952 - October 31, 1955 November 1, 1955-58	A B
New factory buildings	1959 - April 29, 1960 as from April 30, 1960	D E
Other buildings	1952 - April 29, 1960 as from April 30, 1960	B E
Automobiles		
All automobiles	1950-51	A
All automobiles operated by a transport enterprise	1952 - October 31, 1955 November 1, 1955-58 1959 - April 29, 1960 as from April 30, 1960	A B D F
Automobiles not operated by a transport enterprise		
Passenger cars	1952 - April 29, 1960 as from April 30, 1960	B G
Lorries, vans, etc.	1952-58 1959 - April 29, 1960 as from April 30, 1960	B D F
Office furniture and fixtures	1950-51 1952 - April 29, 1960 as from April 30, 1960	A B G
Intangibles	1950-51 1952 1953 - October 31, 1955 November 1, 1955-58 1959 - April 29, 1960 as from April 30, 1960	A C A B D F
Other assets	1950 - October 31, 1955 November 1, 1955-58 1959 - April 29, 1960 as from April 30, 1960	A B D F
Other assets ordered in 1950-52 and not paid for at December 31, 1952		C

- A - the total permissible amount may be written off at once.
 B - restricted to 10% per annum of the cost of acquisition or construction.
 C - in 1952 for certain assets accelerated depreciation was limited to 10% of cost; after that year the limitation was withdrawn.
 D - in the first year the amount is limited to 16 2/3% of cost.
 E - restricted to 6% per annum of the cost of acquisition or construction.
 F - restricted to 8 1/3% per annum of the cost of acquisition or construction.
 G - accelerated depreciation not permitted.

NOTES:

- (1) Possibility D is applicable only if the asset was ordered and acquired after January 1, 1959. For an asset ordered in 1958 and acquired in 1959 possibility B remains applicable.
- (2) Possibilities E, F and G are applicable in respect of fixed assets ordered, or contracted for, subsequent to April 29, 1960. For assets ordered before April 30, 1960 and acquired after that date possibilities A-D remain applicable.

TABLE 6-2

INCOME TAX: RATES OF INITIAL AND INVESTMENT ALLOWANCES
(percentages)
Year of Expenditure

	1946-47 to	1949-50 to	1951-52	1952-53	1953-54 from 25 Apr. 1953	1954-55	1955-56 to 17 Feb. 1956	1956-57	1957-58 from 9 Apr. 1957	1958-59 from 15 Apr. 1958	1959-60 from 7 Apr. 1959 and 1960-61
Initial allowances:											
New industrial buildings } New mining works }	10	10	-	-	(10 {	-	-	10	10	15	5
Dredging } Insulation of industrial and agricultural buildings }	-	-	-	-	(40 {	40 g/	40	40	40	40	20
Fuel-saving plant }	10	10	-	-	10	-	-	-	-	15 g/	5
New ships }	-	-	-	-	20	-	-	-	-	30 g/	10
Ordinary motor cars, second- hand plant and ships }	-	-	-	-	40	-	-	-	-	-	-
Other new plant and machinery }	20	40	-	-	20	20	20	20	20	30	30
					20	-	20	20	20	30	10
Investment allowances: (on new assets)											
Industrial buildings and agricultural forestry buildings and works }	-	-	-	-	-	10	10	-	-	-	10
Mining works }	-	-	-	-	-	20 g/	20 g/	-	-	-	20
Dredging }	-	-	-	-	-	-	-	-	-	-	10
Insulation of industrial and agricultural buildings }	-	-	-	-	-	10	10	10	10	10 g/	10
Fuel-saving plant }	-	-	-	-	-	20	20	20	20	20 g/	20
Scientific research assets d/ Ships }	-	-	-	-	-	-	-	-	-	40	-
Other plant and machinery e/ }	-	-	-	-	-	20	20	20	40	-	40
						20	20	-	-	-	20

a/ Either the initial allowance or the investment allowance may be claimed but not both.

b/ Related to expenditure in the basic period for 1956-57 assessment.

c/ Expenditure of the construction of new ships ordered before 11 April, 1951 continued to qualify for an initial allowance of 40% if the investment allowance was not claimed.

d/ Expenditure on new assets for scientific research has never qualified for the initial allowance as such, but since 1949-50 the annual allowances in the first year have been increased from 20% to 50% and then in the next four years reduced from 20% to 10%.

e/ Including new plant and machinery on the renewals basis but excluding ordinary motor cars.

Source: Commissioners of H.M. Inland Revenue, One hundred and third report (Cmd. 1258; London: H.M. Stationery Office, 1961), Table 25.

TABLE 6-3

HISTORY OF INVESTMENT ALLOWANCE AND DISINVESTMENT ADDITION

Period in which Commitments were Entered into or Self-made Assets Were Manufactured	<u>Investment Deduction</u>		<u>Disinvestment Addition when Sold within 10 years</u>	
	<u>Number of Years</u>	<u>Percentage Per Annum</u>	<u>Number of Years</u>	<u>Percentage Per Annum</u>
April 1, 1953 - Nov. 5, 1956	5	4	5	4
			No addition when sold in the period Nov. 6, 1956 - Dec. 31, 1958.	
Nov. 6, 1956 - May 20, 1958 (except for certain ships and aircraft - see below)....	-	-	-	-
May 21, 1958 - Dec. 31, 1958 (except for certain ships and aircraft - see below)....	4 As from the following book-year	4	4 As from the book-year following the book- year of sale	4
Calendar year 1958. Only for ships and aircraft to be used mainly for international traffic...	5	4	5	4
1959 - April 29, 1960....	2	8	2	8
As from April 30, 1960... (except for certain ships and aircraft - see below)	2	5	2	5
April 30, 1960 until a future date to be determined by a separate Act. Only for ships to be used mainly for inter- national traffic....	2	8	2	8
After that date.....	2	5	2	5
As from April 30, 1960. Only for aircraft to be used mainly for international traffic.....	2	8	2	8

been the history of the investment allowance. Actually, the general trend until recent years has been to make either the investment allowance or the initial allowance available, but not both (see Table 6-1). Like the initial allowance, the investment allowance rates have varied over the years, and is normally granted in the year of assessment for the basis period when the expenditure is incurred, that is, the first year.

A criticism of the initial and investment allowances is their lack of permanency, together with the lack of a stated policy.

Balancing Allowance

The balancing allowance is akin to the Canadian terminal loss. It normally arises when the asset is disposed of. It usually represents the excess of depreciated cost (which is cost less initial, annual and hypothetical allowances) over the sale proceeds. Where assets are accounted for on the group basis, the balancing allowance may be waived by the taxpayer by electing to credit the proceeds to the group account (this is the normal procedure): in Canada, the taxpayer must credit the proceeds to the pool, and can claim the terminal loss only when all the assets in the pool are disposed of.

The converse of the balancing allowance is the balancing charge, which is akin to the recapture provisions in Canadian tax law. The charge cannot exceed the total of the allowances (except the investment allowance, but including the initial allowance) actually or hypothetically granted, thus ensuring that a capital gain on sale will not be taxed.

The rules governing balancing allowances and charges vary by asset classification, and are too detailed to be discussed here. Perhaps their

most significant feature is the role they play where assets are resold, since in many such cases the depreciable cost to the purchaser must reflect the balancing charge or allowance to the vendor.

Anti-Avoidance Provisions

The following provisions apply to industrial buildings, machinery and equipment, patents, and to scientific research facilities:

Where depreciable property is sold at a price other than market, and either

(1) the buyer is a body of persons over whom the seller has control, or the seller is a body of persons over whom the buyer has control, or both the seller and buyer are bodies of persons and some other person has control over both of them, or

(2) it appears that the sole or main benefit of the sale, or of transactions of which the sale is one which might have been expected to accrue to the parties or any of them is the obtaining of an allowance, elaborate provision is made for the adjustment of the tax liability of both buyer and seller. In general, the effect of these provisions is to adjust the tax positions of the parties to what they would have been if the sale had been at market. Thus, the seller's balancing allowance or charge will be computed with reference to the market price rather than the actual proceeds, and the depreciation allowable to the purchaser will be based on market price.

"Body of persons", for purposes of these provisions, includes a corporation and a partnership. "Control", in relation to a company, means the

power to secure, by shareholding or voting power, or powers conferred by the Articles of Association or other document regulating any company, that the affairs of the company are conducted in accordance with the wishes of the person concerned. Control, in relation to a partnership, means the right to a share of more than one-half of the assets or more than one-half the income of the partnership.

It should be noted that in situations described in (1) above, the buyer and seller can jointly elect to have the property treated as though sold for its depreciated cost or at market, whichever is lower.

The adjustments to market will not be made if the transaction qualifies as a "company reconstruction".

The writer assumes that individuals who are party to non-arm's length transactions can be caught under (2) above, but not (1). The anti-avoidance rules will apply to individuals in all cases where the selling price is less than market, but where the selling price exceeds market it must be shown, apparently, that the principal purpose of the transaction is to obtain a depreciation benefit. Perhaps the distinction is rather fine.

Gift

Where depreciable property is gifted, balancing charges or allowances are computed as though the property had been sold at market.

Hire-Purchase

The treatment of payments under a hire-purchase contract is not too clear. The normal form of such an agreement today provides for (1) an advance payment, often described as consideration for the ultimate option to

purchase, (2) a series of monthly payments for hire of the article, which terminate should the hirer return the article, and (3) an option to the hirer, if and when he has paid all the monthly payments, to acquire the article for a nominal sum. It is also common to insert a clause providing for a further payment if the article is returned before the last payment, and there is usually an obligation to maintain the article in good condition. It is apparent that most hire-purchase agreements will involve machinery and plant rather than other depreciable assets, which may explain why the Act apparently provides for the hire-purchase of machinery and plant only.

On such an agreement, the strict view would seem to be that the advance and ultimate payments are capital payments (and, therefore, may be eligible for depreciation allowances), the monthly payments being rental payments are, therefore, a deductible expense. Any other view would appear to disregard the form of the transaction.

The problem has apparently come before the courts but once. 29/ The writer cannot say whether the paucity of litigation on the subject is due to a lack of interest in hire-purchase schemes whether for business or tax-avoidance purposes, or to a general satisfaction with the Revenue's practice. In this case, the agreement was not in the modern form but bound the hirer to pay the stipulated sums throughout the agreement, after which he could acquire the property for a nominal sum. There was no right to cease the payments and return the property. The Court of Session held that there were two separate concurrent agreements—one, an agreement to sell at a future date, and the other, a hiring agreement until that date. The Court also held that a large portion of the payments was really consideration for the option at the future date. Wheatcroft 30/ notes that the option price, as

expressed in the final payment, can be so ridiculously low as to justify the courts in disregarding the form, but submits that this approach is not justified in the modern form of agreement where the down-payment is expressed as consideration for the option and it is clearly contemplated that the hirer may terminate the hiring long before the option arises.

Section 16(2) of the 1957 Finance Act treats the hirer of machinery and plant as owner for purposes of obtaining the initial and investment allowances, but makes no reference to annual allowances. However, section 16(2) does state that where the hirer ceases to be entitled to the benefits of the contract without becoming owner, the 3rd Schedule of the 1957 Act has effect. This schedule provides that where such an event occurs "the expenditure shall be left out of account for purposes of Chapter II of Part X of the 1952 Act", which governs initial, annual and balancing allowances and charges.

In practice, the Revenue ascertains the price of the article, had it been purchased for cash. Initial investment and, it would appear, annual allowances, are then based on the cash price. The difference between the cash price and the total payments is treated as interest and is apportioned actuarially over all the payments, being deductible when paid. Since, owing to the investment allowance, the allowances may ultimately be larger under this method, the Revenue practice may be regarded as a concession, but it involves considerable deferment of tax relief and appears to be open to challenge. 31/

Unused Depreciation

Capital allowances can be used to convert a profit into a loss or to increase the loss for the year, thereby creating or increasing a loss carry

forward. Unused allowances can also be carried forward without attaching them to a loss carry forward.

Movable and Immovable Property

No distinction is made between treatment for depreciation purposes of movable and immovable property as such. It would seem that while industrial buildings will invariably consist of immovable property, machinery, plant and scientific research facilities may have the character of either movable or immovable property, depending on the manner in which they are installed. The statutory definition of "industrial building" (section 271) does not mention elevators, air conditioning, etc.

Leasehold Improvements

A tenant who incurs capital expenditure in the construction, reconstruction or alteration of an industrial building is entitled to depreciate the expenditure in the same manner as if he were the owner, provided the property is occupied by him or his sub-lessee for business purposes. The lessee is thus entitled to depreciate at 2% straight-line and is entitled to the investment and initial allowances. (The duration of the lease is irrelevant to the computation of a lessee's depreciation). On termination of the lease, the tenant is entitled to take a balancing allowance in the amount of the undepreciated cost if the improvement reverts to the lessor without compensation therefor to the lessee. If the lessor compensates the lessee for the improvements, a balancing charge will be made or a balancing allowance given for the difference between that compensation and the undepreciated cost.

DEPRECIATION IN THE NETHERLANDS

Depreciable Assets

All income-producing capital assets, fixed or movable, are depreciable, provided that their useful life is limited. Depreciable assets include goodwill, patents and licence rights.

Basis

The depreciable base is historic cost, which includes the cost of improvements. One source states that the estimated residual value must be taken into account. Replacement value cannot be taken as a basis, though in 1950 businesses were allowed to revalue assets acquired before 1939 by doubling their 1950 net book value. Nor can assets be written up, as in France and Italy, to keep pace, to some extent, with the depreciation of the currency.

Method

Both the straight-line and reducing balance methods are permissible, while for some assets depreciation may be based on utilization, for example, a mileage basis for automobiles, the number of hours a machine is worked. The taxpayer can determine his own system of depreciation (apart from a replacement value system), but once a method has been selected it must be adhered to unless the taxpayer can show that special circumstances justify a change. In practice, the method of writing off a fixed percentage of the original cost has been widely adopted. The chosen method must remain within the limits of sound business practice. The write-off may be based on the economic, as well as the technical, life of the asset. Annual depreciation

may commence as soon as the contract for purchase or improvement is concluded (most other countries do not permit depreciation until a later date). It ceases when an asset is taken out of use. It is not necessary, in claiming depreciation for tax purposes, to set aside corresponding amounts on the books, but if good business practice is to be followed, it would seem that some depreciation would have to be claimed each year, and on a consistent basis.

Rates

As long as the taxpayer remains within the limits of good commercial practice, and his depreciation basis is the cost price, the time in use and the residual value, he may claim depreciation in accordance with his own wishes. Specific rates are not laid down, but the tax inspector may disallow excessive charges. While there are conventional rates in official use, they are not obligatory. The usual rate for machinery is 10%, and 1 1/2% to 3% for buildings. Fixed assets of small value may be written off in the year of acquisition.

If, as a result of any abnormal event (e.g., fire), the value of an asset deteriorates considerably, an extra amount may be written off.

When an asset is disposed of, the difference between the proceeds of disposition and the written-down value is taxable.

Initial Allowance

The initial allowance is a form of accelerated depreciation. It may be claimed from the year in which the asset is acquired, improved, ordered, or made the subject of an invitation to tender for its supply. The initial

allowance is $33 \frac{1}{3}\%$ of the purchase price or manufacturing costs of the asset, and may be taken at will, subject to the provision that it must be spread over at least four years; the maximum initial allowance for any one year is thus $8 \frac{1}{3}\%$. The maximum annual rate for buildings, however, is 6%. No initial allowance is given for office equipment and cars not used for professional road transport.

The combined initial and normal depreciation allowances cannot exceed 100% of the cost of the asset minus residual value where applicable. When the initial allowance is applied, the normal depreciation should be computed on two-thirds of the cost, that is, if the asset costs 9,000 guilders and is normally depreciated at 10%, the initial allowance in the first year will be 750 guilders ($8 \frac{1}{3}\%$ of 9,000) and the normal depreciation will be 600 guilders (10% of 6,000). The initial allowance need not be claimed in the first year, but if it is applied in a subsequent year, the normal depreciation previously applied must be taken into account.

The Minister of Finance may, in agreement with the Minister of Economic Affairs, restrict or suspend the accelerated depreciation facility in general, or in respect of particular asset groups. If this is done, however, the regulation which was effective on the date the asset was contracted for remains in force in respect of that asset.

Investment Allowance ("Investeringsaftrek")

Part of the effect of the investment allowance is the alleviation of the drop in the purchasing power of money, but its primary intention is to encourage capital investment, thereby promoting industrial activity. As in the United Kingdom, the investment allowance is a subsidy granted over and

above depreciation allowances, and enables the taxpayer to write off 10% of the qualifying asset's cost (16% in the case of ships and aircraft used in international transport), in addition to the theoretical 100% write-off stemming from normal and initial allowances.

The available source materials are not explicit on the types of asset which qualify for the investment allowance, but it seems that they will usually comprise equipment or durable means of production. The provisions do not apply to sites not used for industrial building purposes, to residential houses, securities and objects of small value, but they do apply to goodwill, patents and licences.

The investment allowance is granted when debts or manufacturing expenses are incurred in the acquisition or improvement of the asset. The cost of the asset must exceed 3,000 guilders, the 10% allowance is deductible to the extent of 5% in the first year and 5% in the second (8% in each of the first two years in the case of international ships and aircraft). The investment allowance may be used to increase a loss carry-over.

The law excludes transactions which are evidently concluded with a view only to obtaining the investment allowance and are not dictated by business needs. There are also provisions aimed at preventing the misuse of the allowance in transactions between associated companies. Another deterrent to misuse of the facility is contained in a "disinvestment addition", which provides for add-backs when more than 3,000 guilders' worth of assets, in respect of which the investment allowance has been claimed, are sold within 10 years of incurring the debt or expenses arising from the assets' acquisition or improvement. The disinvestment consists of an add-back of 5% of the proceeds to the profits of both the year of disposition and of the following year. (The normal recapture provisions will also result in the excess of

proceeds over undepreciated cost being taxed, though the investment allowance does not, of course, affect the computation of undepreciated cost.) The aggregate amount of all disinvestment additions cannot exceed the aggregate amount of all investment deductions. Moreover, the disinvestment addition for a particular asset sold can never exceed the investment deduction allowed on its acquisition.

As with the initial allowance, the Minister of Finance, in agreement with the Minister of Economic Affairs, may restrict or suspend the investment allowance in general or for particular asset groups. Again, however, the regulation which was effective on the date the asset or its improvement was contracted for remains in force in respect of that asset.

The investment allowance was introduced in 1953, and since its inception the rates have varied, the Regulations have been revised several times and between November 6, 1956 and May 20, 1958, the facility was completely suspended, though the suspension did not affect the allowances in respect of commitments made prior to the suspension date.

DEPRECIATION IN SWEDEN

Swedish law permits generous depreciation allowances for tangible property, and the amortization of certain intangibles. Other capital items subject to depreciation in Canada, such as leasehold improvements, are treated as a business expense in the year incurred.

All depreciable tangible property falls into only two classes: machinery and equipment, and buildings. The two classifications receive radically different treatment. In the first, the taxpayer has the widest discretion; in the second, buildings, depreciation is strictly limited and rigidly controlled.

Depreciation: Machinery and Equipment

Two methods of depreciation are open to the Swedish taxpayer:

- (1) Planned Depreciation (planenlig avskrivning).
- (2) Book Depreciation (rakenskapslig avskrivning).

Planned Depreciation

Planned depreciation is based on an estimate of the actual life of each asset acquired by the business:

As each asset is acquired, the taxpayer divides its actual cost by the number of years of estimated useful life; he deducts the resulting figure annually until the aggregate of deductions has reached the original cost of the asset. [Emphasis added.] The initial calculation of the number of years of estimated life, and the resulting annual deduction, is regarded as the depreciation plan. In estimating the useful life of an asset, physical life is not the only factor to be considered; the possibility of obsolescence and other factors that may limit its economic usefulness to the enterprise must be taken into account.... As examples, the statutory regulations cite the purchase of an item to take advantage either of a development in the economy expected to be only temporary or of a special business opportunity, and the purchase of an item that may have to be exchanged for a new unit because continued use of the original item has become uneconomical even though the item itself is not actually worn out. 32/

Under planned depreciation, the enterprise's depreciation deductions for tax purposes need bear no relation to depreciation taken on its books, except in certain special situations. The taxpayer may use one figure in his books and another in his depreciation plan; it is the latter which governs for tax purposes.

There are some situations where a taxpayer using planned depreciation is allowed to deduct for tax purposes amounts which differ from those permitted by his plan. They are as follows:

Postponed depreciation

In any year, at his option, the taxpayer may take a smaller deduction than that provided for in his plan, (even to the extent that he takes no

deduction at all). By this means he may elect to postpone ordinary depreciation deductions from bad years to good, thus levelling out his tax.

Depreciation resulting in no tax benefit

If, in any year, a taxpayer suffers a loss, or his profit is so small that in whole or in part he derives no tax benefit from the amount of depreciation normally permitted by his depreciation plan, he may take the unused portion in a later year. The accumulated depreciation may be used either by taking a higher than planned deduction in a subsequent year, 33/ or by extending the depreciation beyond the year when, according to the original plan, the asset's useful life would have expired.

There is only one important difference between postponed depreciation and depreciation resulting in no tax benefit. Where depreciation is postponed, the deduction taken (or not taken) for tax purposes must coincide with the depreciation taken for other purposes on the taxpayer's books. Where depreciation results in no tax benefit, this requirement is absent.

Write-down to actual value

The law provides that if the taxpayer can demonstrate that the actual value of an asset has fallen substantially below the value assigned to it under his depreciation plan, he may take an additional deduction sufficient to reduce the asset to its actual value.

Excessive purchase price

If a taxpayer has paid an excessively high price for a piece of machinery, either because it is needed only for a special task or because of temporary shortages or inflated prices, he may, for tax purposes, again vary his plan

by deducting the excess over the normal price in the year in which the excess was spent. 34/

Book Depreciation

Under book depreciation, the alternative method of depreciating machinery and equipment, depreciation may be taken either by declining balance, or by straight-line depreciation. The law prescribes the maximum allowances that may be taken (30% declining balance and 20% straight-line), but sets no minimum allowances. In any particular year, the taxpayer may take less depreciation than that allowed by the ceiling (or none at all), thereby automatically postponing some depreciation to later years. The only substantial requirement is that the amount written off for tax purposes and the amount written off on the books each year must correspond. Hence the origin of the term "book depreciation". Under planned depreciation, as we have seen, this is not the case, and the enterprise's depreciation for tax purposes need not correspond to the depreciation taken on its books for other purposes.

One important difference between the declining balance method and the straight-line method should be noted. Unused straight-line depreciation, having been accumulated, may be used to the full extent of the accumulation, in any year, while, with the declining balance method the annual deduction in any year is limited to 30% of the base. The following example will serve to illustrate how this rule works in practice:

In 1958 a corporation invests Skr 10,000 in new machinery. The company suffers a loss in 1958 and 1959. In 1960 there is a small profit, and the corporation elects to take no depreciation

in that year. But in 1961 there is a large profit, and the company has the option of either:

- (a) Taking up to 30% depreciation, and charging as an expense Skr 3,000, or
- (b) Taking up to 80% depreciation (straight-line) for the four years 1958 to 1961 or Skr 8,000. We see that it is permitted to use its entire accumulation of straight-line depreciation at one time.

A taxpayer who elects to use the straight-line method for one machine in one year is not permitted to use the declining balance method for other machines in the same year. However, he may, at his option, change from the declining balance method to the straight-line method from year to year, providing only that the change affects all his machinery and equipment for that year.

Thus, in the illustration given above, if the corporation took Skr 3,000 depreciation expense in 1961, it could change to straight-line depreciation in 1962 and could, if it so chose, write off the entire balance (Skr 7,000) the following year (the maximum being $\text{Skr } 2,000 \times 5 \text{ years}$ or Skr 10,000). Skr 3,000 having already been taken, there is an accumulation of Skr 7,000, just enough to write off the machine. Thus, the entire purchase price may always be written off in five years. 35/

As in the case of planned depreciation, the taxpayer may "write-down" to actual value machinery or equipment which has in fact dropped below its book value. Actual value is a question of fact. For example, a corporation paid Skr 10,000 in 1958 for a machine which became obsolete in 1960. Under straight-line depreciation the machine would still have a book value of

Skr 6,000; and under the declining balance method, a book value for Skr 4,900. Under the write-down rule the entire balance could be charged to depreciation expense at the end of 1960. A write-down to actual value is also permitted where the purchase price was excessive. In this regard, the rule is the same as that for planned depreciation.

Under both the planned depreciation and the book depreciation systems, short-lived assets, which are defined as machinery or equipment where maximum useful life is three years or less, may be written off as an expense in the year of acquisition.

The law favours planned depreciation, and a taxpayer may change from book depreciation to planned depreciation at his option. Where he wishes to change the other way, from planned depreciation to book depreciation, however, he must obtain the permission of the local tax assessment board.

Depreciation of Buildings

The provisions governing the depreciation of buildings are significantly different from those governing machinery and equipment. There are no fixed rates of depreciation and depreciation unused in one year may not be accumulated and used in a subsequent year. Moreover, in practice, the rates are very low: 0.6% for stone apartment houses, increasing to only 3% to 5% for wooden buildings. ^{36/} The value of a building for depreciation purposes is typically the taxpayer's acquisition cost; ^{37/} replacement cost is not considered. Once acquisition cost has been determined, the annual deduction for depreciation is limited to a fixed percentage of that figure which, as we have seen, is very low. This is true even though obsolescence may be considered when assessing the economically useful life of a structure.

The restrictive rules referred to above are ameliorated in two respects:

- (a) The cost of constructing or reconstructing a building may be charged to an investment reserve for economic stabilization. To that extent, the taxpayer, in effect, receives accelerated depreciation. 38/
- (b) In the case of purely temporary buildings intended to be used for only a few years, the entire cost of construction may be written off in the year of construction. There is no definite rule as to what constitutes a "few years", but it would appear that a structure will be regarded as temporary for purposes of this provision if its life is three years or less.

In the case of a building used in the taxpayer's business, there is a provision for a write-down to actual value, but only where the building becomes entirely worthless. Although there is no statutory provision permitting the immediate write-off of any excess required to be paid above the normal price, the practice is to allow a deduction for this excess.

Disposal of Depreciable Assets

When machinery or equipment is sold or disposed of, the proceeds are treated as income, but against this is offset any depreciation remaining (the book value), and a deduction equal to the price paid for any new machinery purchased in that year. This is the so-called "net method"; its effect is to recognize any gain or loss on the sale.

If a taxpayer sells an item of machinery or equipment in the same year in which it was acquired, he reports the sale price as business income and deducts the acquisition cost as a business expense.

The sale of buildings subject to depreciation does not result in ordinary business income, however. The transaction is treated as a sale of a capital asset and whether any gain is taxable (or loss deductible) depends on the special rules applicable to capital gains. They can be briefly stated as follows:

A gain realized on the sale of a building held for less than seven years is wholly includible in income and is taxed at normal income tax rates. If the building has been held for seven or eight years, 75% of the gain is brought into income; eight or nine years, 50%; nine or ten years, 25%; and over ten years, no part of the gain or loss is taken into account. It is pointed out as follows:

A different situation prevails if a building is demolished or becomes obsolete in the ordinary course of the business. In that case, any salvage value is reported as ordinary income and any undepreciated balance of the acquisition cost may be deducted from ordinary income. 39/

Amortization of Intangibles

Patents and Other Time-Limited Rights

Deductions are allowed for the annual diminution in value suffered by patents and similar time-limited rights acquired by a business for use in its operations. The method of calculating the deduction depends upon how the patent was acquired and what use is being made of it; usually the acquisition cost of the patent or copyright is spread in equal annual deductions over its expected life. As in the case of machinery and equipment, the deductions may be accumulated at the option of the taxpayer.

Goodwill

Costs of acquiring trade-marks, firm names, and similar items in the nature of goodwill which have no specific limit in time are amortizable. Generally, the cost must be deducted in equal amounts over a period of ten years from the time the cost was incurred. A taxpayer who derives no tax benefit from the deduction in any particular year may carry it over to a later year. If he sells goodwill, either separately or as part of a sale of an entire enterprise, the amount received for goodwill is reported as ordinary business income and any undepreciated balance of its cost is deducted as an expense.

Improvements to Leasehold Premises

A tenant who makes permanent improvements to leased property may deduct the cost in the year the expense is incurred, or he may write it off over the life of the lease. Similarly, a bonus or premium paid by a tenant to obtain a lease is deductible. It may be deducted when paid or it may be written off over the life of the lease, again at the option of the taxpayer.

Conclusions

Deductions for capital cost allowance in Sweden show great flexibility. Some expenses which we in Canada treat as capital items, such as leasehold improvements referred to above, or machinery with a useful life of less than three years, are treated in Sweden simply as a business expense, deductible in the year incurred. The wide, and in some cases, unfettered discretion given to the Swedish taxpayer, undoubtedly assists him to average out his income from year to year, to reduce taxation in peak years, and to prevent losses from occurring in other years. We must also conclude that these provisions reduce the effective rate of the tax.

In commenting on the Swedish system, the Harvard Law School World Tax Series states, "The possibility of postponing depreciation deductions [in Sweden]...serves to some extent to take the place of loss carry-overs, which to the present [1959] have not been allowed in Sweden." ^{40/} This statement is outdated, as the law now provides that losses can be carried forward for six years if the net loss incurred is not less than Skr 1,000. Non-corporate taxpayers in Sweden are also permitted to spread their income over three years when income is received in one year which is properly attributable to two years or more. ^{41/} Thus, the Swedish taxpayer has wide freedom to either depreciate his machinery and equipment, or to accumulate his depreciation from year to year—and this in addition to loss carry-over and income-spreading provisions. It can be seen that such treatment places Sweden far ahead of most income-taxing nations in her effort to liberalize depreciation allowances. If greater flexibility is desired in the field of capital cost allowances, and if such changes are economically and administratively desirable, certainly Sweden will serve as the model.

DEPRECIATION IN WEST GERMANY

The laws governing West German depreciation appear to be a jumble of special rules. Each rule is designed to cover a particular situation, and a pattern is not easy to discern. Most capital assets can be depreciated, provided they have a limited useful life. Straight-line depreciation is preferred over the declining balance method, although the latter may be used in some circumstances. Depreciation of income-producing fixed assets is mandatory, and an asset must be depreciated annually even though it may not have been used in the year in question. The German system is, perhaps, the antithesis to the Swedish approach to the same subject.

When using the term "depreciation" in connection with West German income tax, the term must be understood to include amortization and depletion. The law does not distinguish between depreciation and amortization, and its depletion provisions are limited to the rule that enterprises engaged in the extraction of natural resources are permitted to compute depletion in proportion to the exhaustion of the mineral deposit.

Property Subject to Depreciation

If two requirements are met, property may be depreciated. Whether the property is tangible or intangible, it must be held for income-producing purposes. This is the first requirement. The second requirement is that its useful life be limited in time. Thus, with regard to the first requirement, a residence is not depreciable, because it is not held for an income-producing purpose. But if the residence were converted into an apartment house, depreciation would be allowed. If the taxpayer has surmounted the first hurdle (property held for income-producing purposes) he is confronted with the second—that the useful life of the asset be limited in time. This requirement excludes land, ^{42/} goodwill, and investments, but includes tangibles such as machinery and equipment; and intangibles such as leases, patents, secret processes, concessions, franchises, and other similar items. ^{43/}

Rules Governing Depreciation

The depreciation of an asset is based on its historic cost. Changes in the value or price of the asset are not taken into consideration. Where the taxpayer acquires an entire business by gift or inheritance, he is bound by the valuation of the assets in the closing balance sheet of his predecessor.

Depreciation must be taken annually, and may not be postponed from bad years to good. If insufficient depreciation was claimed in a prior year, the taxpayer may be permitted to recover the amount in a later year, but not if the mistake was intentional. However, the recovery of unclaimed depreciation is never permitted if the taxpayer sustained operating losses during the years for which he claimed no depreciation or insufficient depreciation.

An asset may be depreciated in the year it is purchased, but the taxpayer may not claim depreciation for the entire year unless the asset was purchased during the first six months. If it was purchased during the second six months, only half the annual depreciation is allowed.

For depreciation to be claimable for tax purposes, the equivalent amount must be set aside in the taxpayer's commercial accounts. Tax allowances lost through failure or inability to set aside the appropriate amounts cannot subsequently be recovered.

Depreciation Methods

The depreciation methods permitted by West German law are different for movable and immovable property. Movable fixed assets, (e.g., machinery and equipment) may be written off by either the straight-line or the declining balance method. ^{44/} The annual rate of depreciation for such assets is limited to two times the rate applicable for the straight-line method, with an overriding maximum rate of 20% per annum. For immovable fixed assets (i.e., buildings) only the straight-line method ^{45/} of depreciation may be used.

It should be pointed out that the owner of movable property has an option; he may depreciate his property by the declining balance method, or

by straight-line depreciation. In the case of immovable property he has no option; straight-line depreciation is the only method permitted. A taxpayer has the right to elect for each specific movable asset acquired, the straight-line method or the declining balance method. If he has chosen the declining balance method for a specific asset, he can, however, change later to the straight-line method, in which case the net book amount is to be written off in equal instalments over the remaining years of its estimated useful life. On the other hand, if he has, in the first instance, chosen the straight-line method, he may not subsequently change to the declining balance method.

It must be recalled that there is always the problem of distinguishing between movable and immovable property, just as in Canada and other common law jurisdictions there is the problem of distinguishing between real property and fixtures. In Germany, in the case of business property, machines affixed to the real property are depreciated separately from the factory building. The Harvard World Tax series makes the point, however, that this provision only applies where the building is "business property". Improvements, such as an elevator or a heating plant, installed in a building which is not business property, cannot be depreciated separately unless they are put into the building for a limited time (for example, installations made for a particular tenant). 46/

If the building is not "business property" it would appear prima facie that it is not property held for income-producing purposes and would not be depreciable at all. See page 236, supra. It must be concluded that the term "business property" as used here has been given a restricted meaning so that it does not include property held for rental purposes.

Rates of Depreciation

The rates of depreciation are not fixed by statute or even by regulation. The Minister of Finance simply publishes depreciation tables. These tables (a total of about 80 to date) ^{47/} are classified according to branches of industry, commerce, and agriculture, and include assets whose useful life is not dependent on the specific type of enterprise. The existing tables are in the nature of recommendations which reflect experience figures. They do not have official character in the nature of administrative regulations, which implies that the local finance offices can deviate from them in individual cases.

German law expressly recognizes the necessity for increased depreciation because of a reduction in the value of an asset through unusual wear and tear or technical obsolescence. Accelerated depreciation on depreciable property which is subject to heavy strain, used in several shifts, or under similar circumstances, is usually allowed by means of 25% to 50% increases in the regular depreciation rates. The same rules apply to the technical obsolescence of an asset, but a taxpayer claiming extraordinary depreciation on account of obsolescence must be prepared to point to objective facts which justify his request.

The amortization period for protected intangible rights is generally identical with their statutory period of protection. Shorter amortization periods may be required for intangible assets whose usefulness is likely to be exhausted before the expiration of the period during which the right is protected.

Additional or Increased
Depreciation in Certain Cases

Increased depreciation may be given for political reasons. For example, taxpayers who lost their livelihood through Nazi oppression, or through expulsion from the eastern territories of Germany, are entitled to additional depreciation for certain assets (the particulars of which are not relevant to this study). Likewise, considerably higher depreciation rates than those which apply in the Federal Republic can be claimed under certain circumstances for property forming part of an establishment located in West Berlin. Similarly, businesses which are located close to the frontier of East Germany are entitled to special depreciation.

Similarly, additional depreciation may be given for economic reasons. In order to stimulate home construction or reconstruction, owners of residential property are entitled, under certain conditions, to increased depreciation.

Taxpayers engaged in the mining of coal or metallic ores are entitled (in some circumstances) to claim additional depreciation for assets acquired or produced for the erection or improvement of mining shafts and equipment, or for the opening of new mines. The total amount of this increased depreciation (which may be spread over five years) is limited to 50% of cost for movable assets, and 30% of cost for immovable assets. The increased depreciation is in addition to regular depreciation, but there is a restriction: it will be allowed only if the regular depreciation is computed on a straight-line basis.

Additional depreciation is also allowed for administrative and public policy considerations. Items having a small market value (DM 600) may be

fully written off in the year of acquisition, provided that they are for individual use and do not form part of a homogeneous unit.

Equipment designed to remove or reduce air pollution is given special depreciation allowances, as is similar equipment acquired for the prevention or elimination of sewage. Provided the taxpayer computes his regular depreciation on a straight-line basis, this equipment may be written down in the first two years of use by 50% of cost (in addition to regular depreciation).

Conclusion

The source material for this study is unsatisfactory. ^{48/} The number of publications is limited and the treatment is too often superficial. The depreciation tables (referred to supra, page 235) will have to be obtained, translated and examined, before a valid comparison of rates can be made. In our view, German depreciation methods contain nothing which is novel or radical. However, we should note that depreciation has been geared to the country's social and political needs.

REFERENCES

- 1/ The Revenue Act of 1962, Rev. Proc. 62-21.
- 2/ The Internal Revenue Code of 1954.
- 3/ This interpretation of the section is subject to the judicial doctrine that all deductions are a matter of grace, i.e., the onus of proof is on the taxpayer.
- 4/ Limited to a rate not exceeding twice the rate which would have been used under the straight-line method.
- 5/ The "sum of the years-digits" method can best be explained by illustration: assume property with a useful life of 6 years; the taxpayer would compute the sum of 1 + 2 + 3 + 4 + 5 + 6, or 21, and would take a deduction of 6/21 of the property's cost for the first year, 5/21 of its cost for the second year, etc.
- 6/ Which, in turn, is limited to an annual allowance which does not, during the first two thirds of the useful life of the property, exceed what would have been allowed under the declining balance method.
- 7/ Code, section 167(b).
- 8/ Massey Motors, Inc. v. United States, 364 U.S. 92 (1960).
- 9/ Bittker, Federal Income, Estate and Gift Taxation, Second Edition, 1961, p. 267.
- 10/ Straight-line, declining balance, and sum of the years-digits.
- 11/ Section 167(b)(4).
- 12/ Of approximately 5,000 individual items.
- 13/ Section 1.167(a)-1(b).
- 14/ Adda Inc. v. Comm'r., 9 T.C. 199 (1947).
- 15/ T.C. 6182, 6-11-56.
- 16/ Bittker, Federal Income, Estate and Gift Taxation, Second Edition, 1961, p. 263.
- 17/ Code, section 1016(a)(2).
- 18/ Regulations, section 1.167(a)-10(b).
- 19/ Section 1211(a).
- 20/ Section 167(d).

- 21/ Code 1245, Revenue Act of 1962, section 13.
- 22/ Either tangible or intangible.
- 23/ E.g., blast furnaces, oil and gas pipelines, or railroad tracks and signals.
- 24/ E.g., pavements, parking areas, advertising displays, outdoor lighting facilities, or swimming pools.
- 25/ Expenditure is incurred when the sum in question becomes payable.
- 26/ Per Lindley, L.J., in *Yarmouth v. France*, (1887) 19 Q.B.D. 647, p. 658, and approved by the House of Lords in *Hinton v. Maden & Ireland, Ltd.*, (1959), 38 T.C. 391.
- 27/ *Jarrold v. John Good & Sons, Ltd.*, (1962) 2 All E.R. 971.
- 28/ This means any activities in the fields of natural or applied science for the extension of knowledge, but expenditure on the acquisition of rights in, or arising out of, scientific research is excluded, though it may qualify for depreciation as a patent expenditure.
- 29/ *Darngavil Coal Co. v. Francis*, (1913), 7 T.C. 1.
- 30/ G.S.A. Wheatcroft, *The Law of Income Tax, Surtax and Profits Tax*, p. 1272.
- 31/ *Ibid.*, p. 1273.
- 32/ Harvard Law School World Tax Series, *Taxation in Sweden*, Boston: Little, Brown & Co., 1959, pp. 283-284. If the author is to be taken literally, the taxpayer would have the widest discretion in establishing his depreciation by simply reducing or increasing his own estimate of the useful life of the asset. Compare with Price Waterhouse & Co., *Information Guide for Those Doing Business Outside the United States; Sweden*, November 1961, at p. 23, "The cost of machinery and other fixed assets of a permanent nature is deductible in the form of an annual depreciation allowance based on the expected useful life of the asset." We assume that the "useful life of the asset" is a question of fact which is subject to negotiation between the taxpayer and the taxing authorities, although we have no information which bears directly on this point.
- 33/ The use of higher than planned depreciation in a subsequent year requires the approval of the local tax assessment board.
- 34/ Since 1948, use of this provision has generally not been approved by the tax authorities, on the ground that no special conditions exist.
- 35/ Before a taxpayer may use book depreciation, however, he must receive the approval of the local tax assessment board.
- 36/ Price Waterhouse & Co., *op. cit.*, note 1 at p. 27.

- 37/ If the acquisition cost is not known, depreciation may be based on the current assessment value.
- 38/ Since 1938, Swedish corporations and economic associations have been permitted to deduct from taxable income an "investment reserve". In 1955, these taxpayers were permitted to reserve each year up to 40% of net income from business, before taxes, and up to 10% of gross receipts from forestry. Of the sum reserved, 46% must be deposited in a special non-interest-bearing blocked account in the Riksbank, and the remaining 54% of the amount allocated to the reserve may be retained in the business. The reserve may not be used by the corporation without government permission. Harvard Law School, op. cit., note 1 at p. 214.
- 39/ Ibid., at p. 291.
- 40/ Op. cit., note 1 at p. 281.
- 41/ Harvard Law School, op. cit., p. 237.
- 42/ But the cost of improvements which are affixed to the land are capitalized and depreciated, e.g., the cost of planting orchards, and paving roads.
- 43/ Harvard Law School World Tax Series, Taxation in the Federal Republic of Germany, Chicago: Commerce Clearing House, Inc., 1963, at p. 367.
- 44/ Degressive Abschreibung. This includes any variation of the declining balance method acceptable under recognized accounting principles, e.g., sum of the years-digits method would be permissible, but it would have to keep within the statutory limits, infra.
- 45/ Lineare Abschreibung.
- 46/ Harvard Law School, loc. cit., note 2.
- 47/ These tables are not reproduced in any of the publications constituting the source material for this study.
- 48/ Harvard Law School, op. cit., note 2; Price Waterhouse & Co., Information Guide for Those Doing Business in Germany, 1963, pp. 15-19; and Federation of British Industries, Taxation in Western Europe, 1962, 4th (rev.) ed., London, pp. 98-101.

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