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*Apr. 30, May 1 June 25

MONTREAL TRUST COMPANY, Trustee of LODESTAR DRILLING COMPANY, a bankrupt ..... APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE ..... RESPONDENT.

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Taxation—Income tax—Sale of interest in farmout agreement by oil drilling company—Whether proceeds income or capital—Amended tax return not filed within statutory time limit—New issue raised before Supreme Court respecting purchase of farmout interest in United States—The Income Tax Act, 1948 (Can.), c. 52, ss. 3, 4, 12(1)(a) and (b), 42 (4A) (as enacted by 1951 (Can.), c. 51, s. 14) and 127(1)(e)—Income Tax Act, R.S.C. 1952, c. 148, ss. 3, 4, 12(1)(a) and (b), 46(5) and 139(1)(e).

The Lodestar Drilling Co. was incorporated to carry on the business of contractors for drilling oil wells and under its charter was empowered to acquire and sell mineral rights. The company became bankrupt in 1953 and the appellant trust company was appointed trustee. In 1952 Lodestar purchased a half interest in a farmout agreement in consideration of its undertaking to drill a certain well. The estimated cost of drilling the well was more than the company wanted to risk and it therefore sold one-half of its own one-half interest for $27,500. It treated the sum so received as a capital receipt. For the year ending March 31, 1952, Lodestar declared an income of $114,916.05, and for the year ending March 31, 1953, its return showed a loss of $3,516. On September 30, 1953, it filed an amended return for 1952 claiming as a deduction for that year the loss incurred in 1953. On April 28, 1955, the Minister re-assessed the company for the taxation year 1952, adding the $27,500 to the declared income for that year and disallowing part of the 1953 loss previously claimed. In June 1955 the trustee in bankruptcy, after the company's accounts were revised to provide for additional capital cost allowance not previously claimed, filed amended returns for the fiscal years 1952 and 1953, in which a loss of $52,958.57 alleged to have been incurred in 1953 was claimed as a deduction from the 1952 income.

On the two issues raised, *i.e.*, (i) whether the item of $27,500 was properly added to the income by the notice of re-assessment and (ii) whether in June 1955 the trustee could claim an additional capital cost allowance for 1953 so as to increase the loss to be carried back to 1952, appeals by the trustee to the Tax Appeal Board and the Exchequer Court failed. On appeal to this Court a third issue, not dealt with in the reasons of either the Tax Appeal Board or the Exchequer Court, was raised. Close to the time when the company sold the half interest in the farmout agreement, it also purchased an interest in a farmout agreement in the State of Nebraska. It was contended that the amount paid by the company to acquire the latter interest was chargeable against income.

*PRESENT: Taschereau, Locke, Martland, Judson and Ritchie JJ.

Held (Taschereau and Judson JJ. dissenting): The appeal should be allowed in part.

Per Locke, Martland and Ritchie JJ.: The $27,500 received by Lodestar in 1952 was realized from the sale of a capital asset and was not income in its hands. There was nothing in the evidence to support the view that the sale of half the company's interest in the farmout was an activity in the nature of a trade in such properties within the meaning of that expression in s. 139(*e*) of the *Income Tax Act*, R.S.C. 1952, c. 148, as amended. *Irrigation Industries Ltd. v. Minister of National Revenue*, [1962] S.C.R. 346, referred to. This was an isolated transaction, the company not having purchased or sold properties of this nature during the thirteen years of its life. *Western Leaseholds Ltd. v. Minister of National Revenue*, [1960] S.C.R. 10, distinguished.

Per Taschereau and Judson JJ., *dissenting*: Lodestar made no capital investment in the acquisition of the farmout interest. The company, whose business was the drilling of oil and gas wells for others, undertook, in this particular case, to spend its own money to drill on its own account. What it undertook to do was to spend approximately $55,000 in drilling expenses to find out whether there was oil or gas on the property. These drilling expenses being more than the company wished to incur, the receipt of $27,500 before undertaking any development was really a reduction of drilling costs in advance of drilling, with the result that this item was properly included in the company's income.

Per curiam: The second amended return for 1952 having been filed outside the time limit provided by s. 42 (4A), enacted by 1951 (Can.), c. 51, s. 14, the Minister was under no compulsion to act on it. If a taxpayer wishes to carry back business losses, he must file his amended return within the statutory time limit. Otherwise, the Minister cannot be compelled to accept the amended return.

Upon the evidence, the purchase by Lodestar of the interest in the Nebraska property was simply a capital investment and, accordingly, was not a proper charge against the company's income.

APPEAL from a judgment of Dumoulin J. of the Exchequer Court of Canada[1], dismissing an appeal from a decision of the Tax Appeal Board. Appeal allowed in part, Taschereau and Judson JJ., dissenting.

F. R. Matthews, for the appellant.

R. L. Fennerty, Q.C., and *F. J. Dubrule*, for the respondent.

The judgment of Taschereau and Judson JJ. was delivered by

JUDSON J. (dissenting in part):—The appellant is the trustee in bankruptcy of Lodestar Drilling Company Limited, which made an assignment in bankruptcy in October 1953. The appeal is against a re-assessment of the income

[1] [1961] Ex. C.R. 309, C.T.C. 228, 61 D.T.C. 1158.

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of the bankrupt company for the fiscal year 1952. Appeals to the Income Tax Appeal Board and the Exchequer Court[1] have been dismissed.

The company was incorporated to carry on the business of drilling petroleum and natural gas wells. For the year ending March 31, 1952, it declared an income of $114,916.05. For the year ending March 31, 1953, its return showed a loss of $3,516. On September 30, 1953, it filed an amended return for 1952 claiming as a deduction from income for that year the loss of $3,516 incurred in 1953. The result was that the amended return showed a taxable income for 1952 of $111,400.05 instead of $114,916.05.

On April 28, 1955, the Minister re-assessed the company for the taxation year 1952 at $141,342.90. The increase was brought about by the addition to income of a disputed receipt of $27,500 and the disallowance of part of the 1953 loss previously claimed.

In June 1955, the trustee in bankruptcy, following the receipt of the notice of re-assessment in April 1955, filed amended returns for the fiscal years 1952 and 1953. For the 1953 fiscal year the trustee in bankruptcy claimed an additional sum of $51,855.42 for capital cost allowance. This brought the total loss for that year to $52,958.57. The trustee then claimed to apply this 1953 loss against the 1952 income of $141,342.90, bringing the revised income down to the figure of $88,384.33.

Two issues are raised in this appeal:

1. Whether the item of $27,500, being the proceeds of a sale of an interest in a farmout agreement which the company had taken from Trans Empire Oils Limited, was properly added to income by the notice of re-assessment.
2. Whether in June 1955 the trustee could claim an additional capital cost allowance for 1953 so as to increase the loss to be carried back to 1952. It is on both these grounds that the appeal has hitherto failed.

Ground 1. In February 1952 Lodestar purchased through its president an interest in a farmout agreement from Trans Empire Oils Limited. The terms of the purchase were that Lodestar would drill a test well within a certain time and to a certain depth at its sole risk and expense, and would thereby earn an undivided half interest in the Trans

[1] [1961] Ex. C.R. 309, C.T.C. 228, 61 D.T.C. 1158.

Empire lease. In the same month, February 1952, Lodestar made an agreement with Reality Oils Limited to assign a half interest in this farmout for a sum of $27,500. Lodestar proceeded to drill the test well at its own expense and found nothing. The enterprise was abandoned and no further drilling was done on these lands. The substance of the transaction is that Lodestar purchased a half interest in a lease in consideration of its undertaking to drill a certain well; that the estimated cost of drilling this well was more than the company wanted to risk and that it therefore sold one-half of its own one-half interest for $27,500, leaving itself still subject to the obligation to pay the full cost of drilling. The Minister held that this receipt of $27,500 was income from a business within the meaning of ss. 3, 4 and 127(1)(*e*) of the 1948 *Income Tax Act*.

This company was in the business of drilling oil and gas wells for others. In this particular case it undertook to spend its own money to drill on its own account. It made no capital investment in the acquisition of this property. What it undertook to do was to spend approximately $55,000 in drilling expenses to find out whether there was oil or gas on the property. These drilling expenses being more than the company wished to incur, the receipt of $27,500 before undertaking any development was really a reduction of drilling costs in advance of the drilling. This is the Minister's view and I think it is the correct one.

The company's contention that it bought a capital asset, namely, a half interest in an oil lease, which half interest was more than it wanted, fails. It was not buying a capital asset; it was not making a capital investment; it was undertaking to drill for oil at its own expense. By selling a part interest it reduced its cost of drilling. There is really no analogy between this situation and one where a purchaser wants to buy a limited parcel of land and must acquire more because of the vendor's determination. The sale of surplus land, in some such circumstances, might well give rise to a capital receipt. But that is not this case. This company was in the business of drilling for gas and oil. It was carrying on its business when it purchased the interest from Trans Empire Oils Limited. Its sale of the half interest in the interest to be acquired merely reduced the cost to be incurred for drilling. These costs were chargeable against

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income under the provisions of the *Income Tax Act* and they were actually so charged for the year 1952. This branch of the appeal fails.

Ground 2. I have noted above that the company filed its first amended return for the fiscal year 1952 in September 1953. The next amended return was filed after June 27, 1955. This was for the purpose of carrying back the vastly increased capital cost allowance which had arisen as a result of a rewriting of the company's books on instructions from the trustee in bankruptcy after receipt of the notice of re-assessment. The relevant section of the Act as it then stood was s. 42(4A) enacted by c. 51, s. 14, Statutes of Canada 1951. This reads:

> Where a taxpayer has filed the return of income required by section 40 for a taxation year and, within one year from the day on or before which he was required by section 40 to file the return for that year, has filed an amended return for the year claiming a deduction from income under paragraph (*d*) of subsection (1) of section 26 in respect of a business loss sustained in the taxation year immediately following that year the Minister shall re-assess the taxpayer's tax for the year.

The second amended return filed in 1955 does not qualify under this section. When the Minister re-assessed in April 1955, he had before him only the original return and the first amended return. He was under no compulsion to act on the second amended return filed after the notice of re-assessment. Both the Income Tax Appeal Board and the Exchequer Court have so held. The mere fact of a re-assessment in 1955 does not open the matter of taxability at large and compel the Minister to re-assess in accordance with an amended return made out of time, according to the above quoted section. Under this legislation, if a taxpayer wishes to carry back business losses, he must file his amended return within the statutory time limit. Otherwise the Minister cannot be compelled to accept the amended return.

The appellant also raised a third point which has not been dealt with either in the reasons of the Tax Appeal Board or those of the Exchequer Court. Close to the time when the company sold the half interest in the farmout agreement above dealt with, it also purchased an interest in a farmout in the State of Nebraska. This was exactly the converse of the present case. The vendor in the State of Nebraska was obligated to do the drilling and Lodestar was the purchaser in this case of the interest. It happens that it

expended $27,500 for the purchase of this interest. The identity of the two figures is entirely accidental. Lodestar says that the receipt from Reality and the disbursement for the Nebraska property must both be treated in the same way. If the receipt in question in the re-assessment was income, then the disbursement for the Nebraska property is also chargeable against income. Conversely, if the Nebraska disbursement is capital, the receipt from Reality must also be capital. There is some appearance of logic in this argument but I think that the two transactions are easily distinguished in character on the ground

(a) that the disputed receipt came from a sale that was made to reduce drilling costs to be incurred and was in substance a contribution by a co-adventurer to those drilling costs;

(b) that there is no evidence to indicate that Lodestar is entitled to a deduction in the amount of $27,500 in respect of the Nebraska property on the ground that such sum was laid out by the taxpayer for the purpose of gaining or producing income within the meaning of s. 12(1)(*a*) of the *Income Tax Act*, R.S.C. 1952, c. 148.

I would dismiss the appeal with costs.

The judgment of Locke, Martland and Ritchie JJ. was delivered by

LOCKE J.:—The agreement entered into between Trans Empire Oils Ltd. and William Ford on an unspecified date in February 1952, recited that the company was the lessee from the Crown of the petroleum and natural gas rights in Section 31, Township 50, Range 21, West of the Fourth Meridian. This instrument, referred to as a farmout agreement, obligated Ford to commence before February 10, 1952, to drill and carry to completion the drilling of a test well on Legal Subdivision 4 of that section and to continuously thereafter drill until the well was carried to completion. Completion was defined as drilling to a depth sufficient to adequately test the Viking sands, or to a depth where commercial production was found, or to a depth where granite or other impenetrable formation was encountered. In the event that petroleum substances were encountered in quantities sufficient to justify an attempt to place the well on production, Ford agreed at his own expense to take the necessary steps to do this. In the event the well

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was drilled to completion in accordance with these terms it was declared that the Trans Empire Company should be deemed to hold the lease in trust for the use and benefit of Ford, to the extent of an undivided one-half interest in all zones down to the depth to which the well was completed for the remainder of the term of the lease, Ford to be thereafter liable for one-half of the rentals. In the event that the well was productive of petroleum substances, Ford was to be entitled to receive and retain the net proceeds of the production until such time as he had received a sum equivalent to the drilling costs and completion costs of the well. Various other contingencies dealt with by the instrument are irrelevant to the point to be decided.

By an agreement made between Ford and Lodestar Drilling Company Ltd. on an unstated date in February 1952, the former assigned all his interest in the farmout agreement to the Lodestar Company, the latter agreeing to indemnify him against the performance of his obligations under that instrument.

The agreement between the Lodestar Company and Reality Oils Ltd. also made on an unstated date in February 1952, after reciting that under the farmout agreement assigned to the Lodestar Company by Ford that company was entitled to acquire an undivided one-half interest in the Crown lease hereinbefore mentioned, declared that Lodestar assigned to the Reality Company "the full undivided one-half interest in the said Farmout Agreement dated the day of February, A.D. 1952, together with the ful undivided one-half share or interest in all benefits, rights and advantages, subject to the further provisions of this Agreement, which may be derived by Lodestar thereunder in and to the petroleum and natural gas in the hereinbefore recited lands." Lodestar further covenanted to commence and to drill the well to completion and that, if petroleum were found in quantity sufficient to justify production, to fulfil the obligations undertaken by Ford in the farmout agreement and that, after Lodestar had recovered its costs of drilling from the production, the share of the proceeds to which Lodestar should be entitled should be owned by the parties in equal undivided one-half shares.

The Lodestar Company had been incorporated by memorandum of association on March 16, 1949, under the provisions of *The Companies Act* of Alberta. By the

memorandum its objects were declared to include, *inter alia*, carrying on the business of contractors for operating, working, drilling and repairing oil wells and to acquire rights or other interests in wells, claims and places which might seem to be capable of producing petroleum, carbon oils, gas or other mineral substances, and to develop, sell or otherwise deal with the same.

The only witness giving evidence as to the activities which had, in fact, been carried on by the company between the time of its incorporation and the relevant dates was the witness Ford who had been with the company throughout and was, at the time the farmout agreement was entered into, the president and manager. These activities had been carried on in Saskatchewan and Alberta and, with a named exception in the year 1951, had been entirely the drilling of oil and gas wells for others. The exception was that on August 1, 1951, the company had entered into an agreement with Matlo Oils Ltd. and R. R. Dillabaugh, whereby the parties agreed to drill a well on property described in a farmout agreement made by the Lodestar Company, as trustee for the three parties, with Imperial Oil Ltd., the parties agreeing to contribute in defined proportions to the cost of the drilling operations and to the division of any benefits between them in like proportions. The company had not at any time dealt in the purchase and sale of oil or other mineral rights to others.

According to Ford, and there is no contradiction of his evidence, the agreement made by him with the Trans Empire Company was entered into in the hope that, through the discovery of oil, it would produce a steady income for the Lodestar Company. Ford apparently controlled the operations of the company and as the anticipated cost of drilling the well on the farmout in question was about $55,000 he considered this was too big an investment for the company and, accordingly, sold the half interest to the Reality Company for the sum of $27,500.

It was only upon the company drilling the well to completion, as defined, that it became entitled to the specified one-half interest and, at the time the agreement was made with the Reality Company, the company had an equitable interest only in the leasehold interest referred to. The leasehold interest of the Trans Empire Oils Ltd. was an interest

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in land and the interest of the Lodestar Company at the time of the sale to the Reality Company was a right to acquire such an interest. On the face of it, the acquisition of such an interest made for the purpose of obtaining revenue is in the nature of a capital investment.

In the result, when Lodestar drilled the well to completion no production was obtained and the well and the leasehold interest were abandoned. These circumstances do not, however, affect the disposition to be made of this case.

Unlike the arrangement made in the preceding year by the Lodestar Company with Matlo Oils Ltd. and Dillabaugh, there was nothing in the nature of a joint venture between Lodestar Company and the Reality Company for drilling the well and the fact that the purchase price paid by the latter for the half interest in the property apparently was used to pay part of the drilling costs which, in the result, amounted to some $60,000 is an irrelevant circumstance.

Upon the evidence this was an isolated transaction, the Lodestar Company not having purchased or sold properties of this nature during the thirteen years of its life. The learned trial judge, in deciding that the payment received was income in the hands of the present appellant, relied upon the decision of this Court in the case of *Western Leaseholds Ltd. v. Minister of National Revenue*[1], where the judgment of Cameron J. in the Exchequer Court was confirmed. With respect, however, the circumstances in the present matter are quite different, there being in that case a series of dealings in the oil rights of that company conducted in a variety of manners which extended over a period of several years, which the trial judge had found as a fact to be part of its business operations and a carrying on of a business of disposing of such rights.

In the present matter there is nothing in the evidence to support the view that the sale of this half interest was an activity in the nature of a trade in such properties, within the meaning of that expression in s. 139(*e*) of the *Income Tax Act*, R.S.C. 1952, c. 148, as amended. I refer to the review of the authorities dealing with the necessity of showing an adventure in the nature of a trade to be found in the

[1] [1960] S.C.R. 10, [1959] C.T.C. 531, 21 D.L.R. (2d) 385.

judgment of my brother Martland in the case of *Irrigation Industries Ltd. v. Minister of National Revenue*[1].

In my opinion, the $27,500 received by the Lodestar Company from Reality Oils Ltd. was realized from the sale of a capital asset and was not income in its hands.

I have had the advantage of reading the judgment to be delivered in this matter by my brother Judson and I agree with him that the second amended return filed by the trustee in 1955 does not qualify under s. 42(4A), enacted by Statutes of Canada 1951, c. 51, s. 14.

As to the purchase by the Lodestar Company of the half interest in the Nebraska property, upon the evidence this appears to have been simply a capital investment and, accordingly, not a proper charge against the company's income.

I would allow this appeal in part and refer the assessment back to the Minister to delete from the assessment the sum of $27,500 received by the Lodestar Company from Reality Oils Ltd.

As the appellant has succeeded on the principal issue argued before us, in my opinion, it should have its costs in this Court and in the Exchequer Court.

Appeal allowed in part with costs, TASCHEREAU *and* JUDSON JJ. *dissenting.*

Solicitors for the appellant: Allen, MacKimmie, Matthews, Wood, Phillips & Smith, Calgary.

Solicitor for the respondent: A. A. McGrory, Ottawa.

[1] [1962] S.C.R. 346, 33 D.L.R. (2d) 194.