BETWEEN:

THE MINISTER OF NATIONAL REVENUE ..... APPELLANT;

1964
Apr. 20, 21

1965
Mar. 9

AND

HIGHWAY SAWMILLS LIMITED .....RESPONDENT.

Revenue—Income—Income tax—Sale of timber limit after removal of merchantable timber—Capital cost allowance calculation where asset sold in taxation year—Depreciable property—Deduction of proceeds of disposition from undepreciated capital cost—Income Tax Act, R.S.C. 1952, c. 148, ss. 11(1)(a), 20(5)(a) and (e)—Income Tax Regulations 1100(1)(e), (2), (3) and (3)(a), 1101, 1102(2) and 1105, and Schedules B and C.

This is an appeal from a decision of the Tax Appeal Board with respect to the assessment for income tax of the respondent for the taxation year 1957.

The respondent owned a timber limit in the District of Malahat, British Columbia, which it sold to Alaska Pine and Cellulose Company

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Limited on March 4, 1957, at which time the undepreciated capital cost of the limit was $49,370.30. The sale price was $28,800 and the net proceeds to the respondent of the sale were $22,620. The appellant assessed at $26,759 30 the undepreciated capital cost to the respondent of the timber limit at the end of its taxation year, September 30, 1957, arriving at that amount by subtracting the net proceeds of the sale from the $49,379 30, the undepreciated capital cost of the timber limit before the sale on March 4, 1957.

The issue was whether or not the disposal price of bare land, denuded of all merchantable timber, must be deducted from the undepreciated capital cost of the limit immediately prior to its sale to determine its undepreciated capital cost after the sale.

Held: That a timber limit is a property in respect of which a taxpayer is entitled to a deduction under s. 11(1)(*a*) of the *Income Tax Act* and it is therefore "depreciable property" by virtue of s. 20(5)(*a*).

2. That where "depreciable property" has been disposed of the proceeds of disposition are to be deducted from the amount that would otherwise be the undepreciated capital cost of property of that class in order to determine undepreciated capital cost within the meaning of that expression as defined by s. 20(5)(*e*) of the *Income Tax Act*.

3. That the respondent can deduct under Regulation 1100(2) of the *Income Tax Act* only the amount that would otherwise be the undepreciated capital cost of the limit at the end of the year as determined under s. 20(5)(*e*).

4. That the appeal is allowed.

APPEAL from a decision of the Tax Appeal Board.

The appeal was heard by the Honourable Mr. Justice Dumoulin at Victoria.

D. M. M. Goldie, R. A. C. McColl and *G. F. Jones* for appellant.

K. E. Meredith for respondent.

The facts and questions of law raised are stated in the reasons for judgment.

DUMOULIN J. now (March 9, 1965) delivered the following judgment:

The Minister of National Revenue has appealed from a decision of the Tax Appeal Board, dated May 10, 1963, respecting an income tax assessment for the respondent's 1957 taxation year.

The appellant asserts that, during its 1957 taxation year, the respondent owned a timber limit, consisting of several blocks east of the Sooke River, District of Malahat, B.C., which had an undepreciated capital cost of $49,379.30, immediately prior to a sale of these holdings to Alaska Pine

and Cellulose Company Limited, on March 4, 1957 (cf. exhibits Z-7 and Z-8).

The sale price was $28,800 (cf. ex. Z-8) which, after deducting commission and sundry selling expenses, the Minister estimated, in net proceeds, at $22,620, a valuation uncontested by respondent in paragraph 3(*e*) of its Reply to Notice of Appeal.

In consequence of the disposal aforesaid, Highway Sawmills, at the end of 1957, no longer retained any proprietary title in this limit, a fact that induced the appellant to assess at $26,759.30 the "undepreciated capital cost" to respondent company of this timber limit at the end of the taxation year which terminated on September 30. The above figure of $26,759.30 was reached by subtracting the sale price—net proceeds—of $22,620 from $49,379.30, undepreciated capital cost of the timber limit before the transaction of March 4, 1957.

Highway Sawmills' claim of $45,411.42 capital cost allowance for its timber limits during taxation year 1957 was disallowed and, in lieu thereof, a deduction of $26,759.30 was permitted.

The appellant relies, *inter alia,* upon sections 11 and 20 of the *Income Tax Act,* R.S.C. 1952, chapter 148, and upon section 1100 and Schedule C of the *Income Tax Regulations.* (Notice of Appeal, para. 5).

Paragraphs 6 and 7 of appellant's pleadings respectively set out the twofold basis of this appeal, namely: that the respondent, having sold the timber limit prior to end of its 1957 taxation year, was not entitled, in computing its income, to any deduction under regulation 1100(1)(*e*) and Schedule "C" (Notice of appeal, para. 6); but, on the other hand, that respondent was entitled to and allowed a $26,759.30 deduction, pursuant to regulation 1100(2), the latter amount representing, in the Minister's estimation, the undepreciated capital cost of the timber limit as of September 30, 1957, closing date of Highway Sawmills' fiscal year. (para. 7)

Conflicting with this view, the respondent asserts that it had purchased certain timber limits anteriorly to 1957 "for the purpose solely of logging timber therefrom . . . and the price therefor was fixed with reference to the value of the timber thereon with no allowance whatsoever for land" (Reply to Notice of Appeal, para. 3(*c*).) In paragraph 3(*d*)

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the company goes on to say that: "Between the years of the acquisition of the said Blocks and the end of the fiscal year of the Respondent 1957, the Respondent logged all the merchantable timber from the timber limits aforesaid . . ." and, consequently, the full purchase price of those lands was deducted from income as capital cost allowance. Paragraph 3(*e*), after mentioning the sale for $22,620 to Alaska Pine and Cellulose Ltd., during 1957 (March 4), specifies Highway's basic interpretation of the transaction, which would have been: ". . . entirely fortuitous insofar as the Respondent was concerned, the Respondent considering at all material times that the land had no value . . . save, of course, that of the timber growing on it, and, therefore, the sum brought in by the sale of the bare ground . . . constituted a capital receipt . . . and a windfall." (This last quotation excerpted from para. 7.)

The respondent, attaching a different meaning to sections 11 and 20 of the Act, relies on those statutory enactments and also upon Regulations 1101, 1105 and Schedules B and C thereof.

Unravelling the interplay of the pertinent legal provisions herein, albeit lucidly drafted, is by no means a simple task and calls for a considerable degree of concentration in order to distinguish what to a layman might seem Ariadne's clew. In point of fact, the issue narrows down to deciphering which Regulations and Schedule should govern, but, as we shall see, a rather intricate statutory skein must be unwound before the labyrinth's exit is reached. Once again, let us bear in mind the question awaiting a solution: whether or not the disposal price of bare land, denuded of all merchantable timber, must be deducted from the undepreciated capital cost of the limit immediately prior to its sale to determine its undepreciated capital cost after the sale.

The respondent was entitled, during the years following the purchase of the timber limit, to deduct capital cost allowance under the following provisions:

(1) section 11(1)(*a*) of the *Income Tax Act* which authorizes a deduction in computing a taxpayer's income for a taxation year of "such part of the capital cost to the taxpayer of property . . . as is allowed by regulation";

(2) Regulation 1100(1)(*e*) which provides for an allowance under paragraph (*a*) of section 11(1) of "such amount as he may claim not exceeding the amount

calculated in accordance with Schedule C in respect of the capital cost to him of a timber limit. . .";

(3) Schedule C to the Income Tax Regulations which sets out a formula for determining the amount of the annual deduction in respect of the capital cost of a timber limit.

During the 1957 taxation year, the respondent disposed of the timber limit (which, by virtue of Regulation 1101(3) is a prescribed class) and was therefore entitled, by virtue of Regulation 1100(2), (*infra*), to a deduction "equal to the amount that would otherwise be the *undepreciated capital cost* of property of that class at the expiration of the year".

Regulation 1101(3) enacts the following:

(3) For the purpose of this Part and for the purpose of Schedules C and D

(*a*) a timber limit or a right to cut timber from a limit shall be deemed to be a separate class of property . . .

Undepreciated capital cost is defined by section 20(5)(*e*) of the *Income Tax Act*:

(*e*) "Undepreciated capital cost" to a taxpayer of depreciable property of a prescribed class as of any time means the capital cost to the taxpayer of depreciable property of that class acquired before that time minus the aggregate of

(i) the total depreciation allowed to the taxpayer for property of that class before that time,

(ii) for each disposition before that time of property of the taxpayer of that class, the least of

(A) the proceeds of disposition thereof,

(B) the capital cost to him thereof, or

(C) the undepreciated capital cost to him of property of that class immediately before the disposition, and

(iii) each amount by which the undepreciated capital cost to the taxpayer of depreciable property of that class as of the end of a previous year was reduced by virtue of subsection (2).

It may be worthwhile to note that since the decision by this Court of *Caine Lumber Company v. Minister of National Revenue*[1], April 16, 1958, affirmed by the Supreme Court of Canada[2], April 28, 1959, paragraph (*a*) of s. 20(5) was amended in 1959 (S.C. c. 45, s. 6 (1)) by closing the quotation marks after the word "property" in the first line rather than as formerly after the word "taxpayer", same line. Similiarly, para. (*e*) of s. 20(5) was amended (1959, S.C. c. 45, s. 6(3)) by closing the quotation marks after the word "cost" in the first line, rather than, as previously,

[1] [1958] Ex. C.R. 216. [2] [1959] S C R 556.

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after the word "property" in the same line. Possibly those slight variations intended bringing the definitions closer to the current acceptation of the bracketed terms and more in line with the remarks of Mr. Justice Locke, at p. 561 of the *Caine Lumber* case (*supra*).

Once more, let us look at the deductions allowed in computing income particularly at paragraph (a) subsection (1) of section 11, providing for fiscal allowances in relation to capital cost of property:

> (*a*) 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.

This refers the matter to Part XI of the Regulations, entitled "Allowances in Respect of Capital Cost", under which appear Regulation 1100, subsection (1) and paragraph (*e*), this latter disposition captioned "Timber Limits and Cutting Rights"; I quote:

> 1100. (1) Under paragraph (*a*) of subsection (1) of section 11 of the Act, (dealing with capital cost of property) there is hereby allowed to a taxpayer in computing his income from a business or property, as the case may be, deductions for each taxation year equal to
>
> . . . .
>
> (*e*) such amounts as he (the taxpayer) may claim not exceeding the amount calculated in accordance with Schedule C in respect of the capital cost to him of a timber limit or a right to cut timber from a limit.

Next in line as affording a general direction are subsections 2, 3 and 3(*a*) of Regulation 1100, hereunder:

> (2) Where, in a taxation year, otherwise than on death, all property of a prescribed class that had not previously been disposed of or transferred to another class has been disposed of or transferred to another class and the taxpayer has no property of that class at the end of the taxation year, the taxpayer is hereby allowed a deduction for the year equal to the amount that would otherwise be the undepreciated capital cost to him of property of that class at the expiration of the taxation year.

Paragraph (3) hereunder also bears the specific title of "Timber Limits or Cutting Rights":

> (3) For the purpose of this Part and for the purpose of Schedules C and D
>
> (*a*) a timber limit or a right to cut timber from a limit shall be deemed to be a separate class of property . . .

I might also mention regulation 1102(2) to the effect that:

> (2) The classes of property described in Schedule B shall be deemed not to include the land upon which a property described therein was constructed or is situated.

Before passing on to Schedule C, it may be of some interest to ascertain the nature of the transactions between

Highway Sawmills Limited and Alaska Pine Company as stated in exhibits 7 and Z-8.

Exhibit 7, dated July 26, 1956, is an option "open for acceptance by the Optionee" (Alaska Pine Co.) until the 24th day of September 1956, whereby for the sum of $30,000 the Optionor (Highway Sawmills Ltd.) promises to sell "the lands and premises (description follows) . . . together with all timber (except as herewith provided) . . .", an exception of no indifferent significance, reserving to Highway Sawmills ". . . the right to cut and remove free of charge all merchantable timber on said lands for a period of two years from the date of such acceptance, together with all necessary rights-of-way over any roads crossing said lands whether presently in existence or constructed by the optionor or the optionee during said two-year period".

Exhibit Z-8, dated the 4th day of March, 1957, is the deed of sale whereby Highway Sawmills, for a price of $28,800, conveys unto Alaska Pine Company the full ownership in fee simple of certain designated lands in the Malahat and Otter Districts, Vancouver Island, "save as set out in Schedule "A" hereto . . ." The grantor company thereby reserved to itself "the right to enter upon all or any part of the lands described . . . for the purpose of felling, cutting and removing all merchantable timber now standing, lying or being on the said lands and for such purposes to use any existing roads on the said lands and to construct and use such other roads on the said lands as the Grantor may deem necessary, provided however that the Grantor shall conduct its operations in such a manner as to minimize any damage to other timber growing on the said lands; and the rights hereby reserved to the Grantor shall terminate on the 20th day of September, 1960, or so soon as the Grantor shall have removed . . . all merchantable timber now standing, lying or being thereon . . .".

Mr. John Williams White, office manager of Highway Sawmills (in voluntary liquidation since 1960), testified his company "had no intention of selling logs over lands, but being offered $15.00 an acre for 2,002 acres we nevertheless decided to accept that windfall". The witness explains that his firm "hoped to get rid of the ground for unpaid taxes after cutting all merchantable timber".

It remains uncontested that immediately prior to the disposal deed of March 4, 1957 (exhibits Z7 and Z8) the

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undepreciated capital cost was $49,379.30. Then, at the date aforesaid, the respondent, reserving to itself during three years and six months, viz. March 4, 1957, September 20, 1960, the right to cut and remove the entire timber crop, sold the land and received therefor a price of $22,620. Under such circumstances it would be difficult, I believe, to deny the applicability of subsection (2) of Regulation 1100, next repeated for convenience's sake, with some deletions:

> 1100. (2) Where, in a taxation year, . . . all property of a prescribed class . . . has been disposed of . . . and the taxpayer has no property of that class at the end of the taxation year, the taxpayer is hereby allowed a deduction for the year equal to the amount that would otherwise be the undepreciated capital cost to him of property of that class at the expiration of the taxation year.

The appellant has set at $49,379.30 the undepreciated capital cost to respondent of the limit immediately prior to its disposal, a figure undisputed and exceeding the capital cost allowance of $45,411.42 claimed by Highway Sawmills for 1957. Out of the valuation of $49,379.30, a fraction, or $22,620, was paid into the company's coffers. The agreed figure of $49,379.30 remains undisturbed, save that the respondent received an important portion of it. The sale price of $22,620 plus the deduction allowed of $26,759.30, add up to $49,379.30.

In brief, applying section 20(5)(*e*)(ii) (*supra*) the Minister deducted the proceeds of sale from the undepreciated capital cost as it was before the sale and determined that "the undepreciated capital cost of property of that class at the expiration of the year", deductible under Regulation 1100(2), was $26,759.30.

The respondent contends that Regulation 20(5)(*e*)(ii) does not apply when what was disposed of was, in effect, bare land. He contends that there is a principle that land is not depreciable property.

The only principle of law concerning land in respect of capital cost allowance is Regulation 1102(2) which reads as follows:

> (2) The classes of property described in Schedule B shall be deemed not to include the land upon which a property described therein was constructed or is situated.

This provision concerning land applies only to property described in Schedule B to the Income Tax Regulations. It has no application to property described in Schedule C.

The respondent also claims that land is not a "depreciable

asset" but is a "depletable asset". The answer to that contention is that a timber limit is a property in respect of which a taxpayer is entitled to a deduction under section 11 (1)(*a*) and it is therefore "depreciable property" by virtue of section 20(5)(*a*), which reads:

> (*a*) "depreciable property" of a taxpayer as of any time in a taxation year means property in respect of which the taxpayer has been allowed, or is entitled to, a deduction under regulations made under paragraph (*a*) of subsection (1) of section 11 in computing income for that or a previous taxation year;

It is clear where "depreciable property" has been disposed of, that the proceeds of disposition are to be deducted from the amount that would otherwise be the undepreciated capital cost of property of that class in order to determine undepreciated capital cost within the meaning of that expression as defined by section 20(5)(*e*). Each timber limit is a prescribed class of depreciable property. The respondent's claim to deduct $45,411.42 is based on section 11(1)(*a*) of the Act and the Regulations made thereunder. It follows that it can only deduct under Regulation 1100(2) the amount that would otherwise be the undepreciated capital cost of the limit at the end of the year as determined under section 20(5)(*e*).

For the reasons above, the Court reaches the conclusion that the respondent's 1957 taxation year was properly assessed, and would therefore allow the appeal with costs in favour of the appellant.

Judgment accordingly.