1954
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BETWEEN:

OKALTA OILS LIMITED ..... APPELLANT;

AND

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

Revenue—Income—Income tax—The Income War Tax Act R.S.C. 1927, c. 97, s. 8(6)—Allowable deductions—Oil wells—Expenditures on dry oil wells—Wartime Oils Limited—Financial assistance given by Wartime Oils Limited in drilling oil wells—Effect of s. 8(6) of the Income War Tax Act—Interpretation of s. 8(6) of the Income War Tax Act—Appeal from Income Tax Appeal Board dismissed.

Section 8(6) of the Income War Tax Act, R.S.C. 1927, c. 97 is as follows:

(6) A corporation whose principle business is the production, refining or marketing of petroleum products is entitled to deduct from

(*a*) the aggregate of the taxes under this Act and The Excess Profits Tax Act, 1940, payable by it in respect of the year of expenditure, and

(*b*) if the deduction permitted under this subsection exceeds the taxes so payable in that year, from the taxes so payable in subsequent years,

an amount equal to

(*c*) twenty-six and two-thirds per centum in the case of a corporation substantially all of whose income is subject to depletion under this Act, or

(*d*) forty per centum in the case of any other corporation, of the aggregate of drilling and exploration costs, including all general geological and geophysical expenses, incurred by it directly or indirectly on oil wells spudded in during the period from the first day of January, nineteen hundred and forty-three to the thirty-first day of December, nineteen hundred and forty-six and abandoned within six months after completion of drilling.

In 1943 appellant company which held certain oil leases on property in Turner Valley entered into an agreement with Wartime Oils Limited —a Crown corporation—by which it received subject to certain terms and conditions financial assistance in drilling, among other wells on its property, Well No. 20. The well was spudded in on January 18, 1944, and finally abandoned on December 18, 1944. The amounts received in 1944 and 1945 for drilling and cleaning up expenses totalled approximately $220,000.00 which more than covered its out-of-pocket expenses on the operation. Having faithfully carried out its part of the agreement appellant company, by reason of a clause to that effect therein, was under no liability to repay the moneys advanced by Wartime Oils Limited. It transferred the whole of the amount so received to capital surplus and in computing its tax for the taxation year 1946 claimed the benefit of the provisions of s. 8(6) of the Act. The claim was disallowed by the Minister on the ground that appellant company incurred no drilling or exploration costs in relation to that well and that if any such costs were incurred, they were incurred

by Wartime Oils Limited. An appeal from the assessment was taken to the Income Tax Appeal Board which dismissed the appeal and from that decision appellant appealed to this Court.

Held: That the effect of s. 8(6) of the Income War Tax Act is to enable a taxpayer who has incurred costs in drilling an oil well which has proven unproductive, to recover by means of tax deductions the amounts which he is out-of-pocket by reason of such costs and which he could not otherwise recover. The probability—if not the certainty—that such losses would be recovered, provides the incentive for extending his operations by further drilling. The general intent of the enactment is to place the taxpayer in such cases in the position where he would suffer no loss so far as the unproductive operation is concerned—that he would not be out-of-pocket.

2. That to construe s. 8(6) of the Act so as to enable a corporation which is not out-of-pocket on its operation, but on the contrary has had all its expenses paid for by another party—here a Crown corporation—to be repaid for such expenses out of taxes which would otherwise accrue to the Crown, would mean that the legislation was intended to confer not only indemnity for such losses, but also an additional bonus of a like amount, an interpretation Parliament did not contemplate.

APPEAL from a decision of the Income Tax Appeal Board.

The appeal was heard before the Honourable Mr. Justice Cameron at Calgary.

J. M. Robertson for appellant.

H. W. Riley, Q.C. and *J. D. C. Boland* for respondent.

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

CAMERON J. now (January 7, 1955) delivered the following judgment:

This appeal involves questions arising out of an assessment made upon the appellant company in respect of its taxation year ending December 31, 1946. The substantial question is whether the appellant in computing its tax had the right on the particular facts of this case to apply the provisions of section 8(6) of the Income War Tax Act relating to certain deductions from taxes and applicable in certain circumstances with respect to drilling and exploration costs incurred on oil wells which proved to be unproductive and were abandoned. An appeal from the assessment was taken to the Income Tax Appeal Board which, by its decision dated September 3, 1953 (9 T.A.B.C. 65), disallowed the appeal, and a further appeal is now taken to this Court.

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At the hearing of the appeal the parties filed an agreed Statement of Facts, and while each reserved the right to call witnesses, it was found unnecessary to do so. The appeal therefore is to be determined on the facts as agreed upon and the applicable provisions of the Act.

The appellant was incorporated in 1925 and it is agreed that at all material times its principal business was the exploration for and the production of petroleum. Subsection (6) of section 8 of the Act is as follows:

> (6) A corporation whose principal business is the production, refining or marketing of petroleum or petroleum products is entitled to deduct from
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> (*a*) the aggregate of the taxes under this Act and The Excess Profits Tax Act, 1940, payable by it in respect of the year of expenditure, and
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> (*b*) if the deduction permitted under this subsection exceeds the taxes so payable in that year, from the taxes so payable in subsequent years,
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> an amount equal to
>
> (*c*) twenty-six and two-thirds per centum in the case of a corporation substantially all of whose income is subject to depletion under this Act, or
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> (*d*) forty per centum in the case of any other corporation, of the aggregate of drilling and exploration costs, including all general geological and geophysical expenses, incurred by it directly or indirectly on oil wells spudded in during the period from the first day of January, nineteen hundred and forty-three to the thirty-first day of December, nineteen hundred and forty-six and abandoned within six months after completion of drilling.

Now it is not disputed that in some circumstances the appellant is entitled to the benefit of that subsection. In fact, in assessing the appellant for the year 1946, tax credits under that subsection were allowed to the appellant in respect of one of its wells which proved to be unproductive, namely, Keho Lake No. 1. In the main, however, the appellant's claim to the benefit of subsection (6) relates to expenditures on Well No. 20. The respondent, in effect, disallowed any claim in regard thereto on the ground that the appellant incurred no drilling or exploration costs in relation to that particular well and that if any such costs were incurred, they were incurred by Wartime Oils Limited.

It becomes necessary, therefore, to consider the special facts relating to Well No. 20 and the manner in which its drilling was financed. In view of my conclusions, it is not necessary to state in detail the particulars of the amounts involved.

During the Second World War it was found necessary to encourage and stimulate the production of oil in Canada; accordingly, by P.C. 3567 of May 4, 1943, authority was given under the War Measures Act for the incorporation of a Crown corporation—Wartime Oils Limited—charged with the duty of negotiating and entering into contracts for the carrying out of said objective and for the furnishing of financial assistance in connection therewith. The appellant company held certain oil leases from the Government of Alberta on property in Turner Valley. It entered into a series of agreements with Wartime Oils Limited by which it received financial assistance in drilling certain wells on its property.

Exhibit 1, dated December 30, 1943, is a photostatic copy of the agreement relating to the drilling of Well No. 20 and is similar to the others. Thereby the appellant undertook to drill the well in accordance with certain specifications; Wartime Oils agreed to finance all the costs of the drilling and for that purpose to deposit the necessary funds with the Trusts and Guarantee Co. Ltd (also a party to the agreement) as trustee. The trustee was to disburse the money so received to the appellant at the times and in the amounts specified in the agreement and the schedule thereto, upon the requisition of Wartime Oils or upon the requisition of the appellant when approved for payment by a representative or appointee of Wartime Oils. All moneys so advanced to the appellant were to be repaid to Wartime Oils, together with interest at 3½ per cent, but only out of the proceeds of oil produced from the said well (or from a second well which might be drilled on the same premises if the first well proved to be unproductive). It was further provided that after repayment of the said loan and interest, Wartime Oils would become entitled to a royalty in perpetuity of ¼ of 1 per cent of the petroleum and natural gas produced, for each $12,500.00 of such advances. As security for the advances to be made, the appellant assigned to the trustee that part of the leased lands on which Well No. 20 was located; and mortgaged to Wartime Oils all its interest in the petroleum therein and in the surface rights and property thereon, and also on the production from any well or wells (subject only to the prior payment and deduction of royalties and the operating

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expenses of the appellant company). The appellant assigned to the trustee the whole of the production of petroleum and natural gas to be produced from the said well.

Well No. 20 was spudded in on January 18, 1944; drilling was completed on August 8, 1944, and after attempted acidization, etc., the well was finally abandoned on December 18, 1944. The major part of the drilling expenses was incurred in 1944; but in 1945 further expenses were incurred in cleaning up the site and certain settlements were arrived at regarding items of expense which had not previously been settled. In these two years the appellant received from the trustee on behalf of Wartime Oils a total of about $220,000.00, an amount which more than covered its out-of-pocket expenses, the balance being referable to management costs, overhead, depreciation on the equipment used, and matters of that sort.

Clause 27 of the agreement (Exhibit 1) provided as follows:

> So long as the Company shall duly and faithfully perform and observe the covenants and agreements on its part herein contained or implied and shall commit no breach or default thereof, there shall be no obligation upon it to repay the monies advanced by Wartime Oils, and interest thereon, except out of the proceeds of production of the well or wells in respect of which such advances are made, the proceeds of disposal of casing and equipment thereof and any monies which may become payable under the bond referred to in paragraph 26 hereof.

No question arose as to the manner in which the appellant had carried out its contract. By reason, therefore, of clause 27, the appellant was under no liability to repay to Wartime Oils any portion of the moneys which it had received, and of course Wartime Oils was not entitled to any royalty under that agreement.

The appellant under these conditions transferred the whole of the amount so received to capital surplus. It now seeks to claim the benefit of the provisions of section 8(6) of the Act in relation to those amounts (as well as on certain royalty matters to which I shall refer later).

Counsel for the appellant, as I have said, submits that all such costs were in fact "incurred" by the appellant. He points out that the appellant had full charge of the drilling; that it became primarily liable for costs of labour and material and did in fact pay for them. He submits that the

agreement (Exhibit 1), properly interpreted, establishes that Wartime Oils made a loan to the appellant, and he refers to paragraph 6 thereof which states that Wartime Oils "agrees that by way of loan to the company (i.e. the appellant) it will provide the trustee with the amounts required". He also refers to the other terms of the agreement by which provision is made for the repayment of the advances with interest, for the taking of a mortgage and the giving of an assignment of the lease and of the production as further indicia that it was a loan. He says that as the moneys were advanced under the "loan", they became the property of the appellant and that when expended by it for labour and material, such expenditures were made by the appellant and were made out of its own funds. He says, therefore, that the appellant not only incurred but paid such costs and that its positions is precisely the same as if it had secured funds by way of a bank loan or by issue of debentures or the like. He points out, also, that in certain circumstances—such as the appellant company defaulting on its agreement—the "loan" would have had to be repaid even if the well had been found unproductive. Finally, he says that the mere fact that the moneys received did not in the result become repayable has no bearing on the matter.

The argument is persuasive and I must admit that on first consideration I felt it had considerable merit. Upon further consideration, however, and after examining the provisions of subsection (6) and endeavouring to ascertain its true purpose and meaning, I have reached the conclusion that it must be rejected.

Subsection (6) is incentive legislation designed to encourage the production of oil and oil products. It is well known that drilling for oil is an expensive operation which in many cases results in no production. The subsection permits the specified corporations to deduct from their total tax liability under both the Income War Tax Act and The Excess Profits Tax Act the stated percentages of the costs incurred on expenditures on dry oil wells within the five years mentioned. There is no limitation as to the amount of such expenses and as I understand the matter, the result of the application of the formula laid down

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(which involves a deduction from the taxes otherwise payable and not from the taxable income) is that all of such costs may be eventually recovered over a period of one or more years. The effect of the subsection, it seems to me, is to enable a taxpayer who has incurred costs in drilling an oil well which has proven unproductive, to recover by means of tax deductions the amounts which he is out-of-pocket by reason of such costs and which he could not otherwise recover. The probability—if not the certainty—that such losses would be recovered, provides the incentive for extending his operations by further drilling. The general intent of the enactment is to place the taxpayer in such cases in the position where he would suffer no loss so far as the unproductive operation is concerned—that he would not be out-of-pocket.

On that construction of the subsection, it seems to me that the appellant must fail on this point. The agreement was made in such a way as to provide that there was no possibility of the appellant sustaining any loss whatever on the drilling operation of Well No. 20, provided that it faithfully carried out the agreement. The fact is that it suffered no loss but made a profit on the operation, the whole of its costs having been paid by Wartime Oils. While it may perhaps be said that from one point of view the appellant "incurred" the costs by becoming liable and paying the costs of labour and material, it cannot be said in the light of what occurred that it suffered or was put to any loss or that on the operation it was out-of-pocket. I find it impossible to put upon the subsection such a construction as would enable a corporation which is not out-of-pocket on its operation, but on the contrary has had all its expenses paid for by another party—in this case a Crown corporation —to be repaid for such expenses out of taxes which would otherwise accrue to the Crown. To do so would mean that the legislation was intended to confer not only indemnity for such losses, but also an additional bonus of a like amount, an interpretation which I think Parliament did not contemplate. For these reasons, the appeal, so far as it relates to the direct drilling and exploration costs, is dismissed.

In its claim the appellant included also three items called "gross royalty to Wartime Oils Limited"; in 1944 the amount was $16,000.00 and in 1945 $2,000.00, both referable to Well No. 20; the remaining item of $1,000.00 was referable to Well No. 18, a companion well of Well No. 15 which was drilled under a similar contract with Wartime Oils and found productive, Well No. 18 being commenced but not drilled.

These items arose in this way. As I have said, the agreements provided that in the eventual production of oil or gas from the respective lands, Wartime Oils was to acquire in perpetuity a gross royalty percentage in the production of the well, computed at $\frac{1}{4}$ of 1 per cent for each $12,500.00 advanced by it in respect of such well. The appellant's directors considered it proper to record in their accounts the value of the gross royalty interest in such potential production. Having regard to market prices for such interests, they fixed an amount of $4,000.00 for each 1 per cent of the gross royalty so to be acquired by Wartime Oils and on that basis, as the total advances for each well were determined, an entry was made charging expenditures on wells and crediting leases with the value of the interest. As the companion well of Well No. 18 was productive, Wartime Oils might at some date acquire a $\frac{1}{4}$ of 1 per cent royalty in perpetuity therein, but in the result it never could acquire any royalty in connection with Well No. 20 or its companion Well No. 22. The total of these three items—namely, $19,000.00—was charged as expenditures and written off to profit and loss. It is now sought to include the total amount as "expenses" in the same manner as was done in regard to the drilling and exploration costs and to apply the provisions of section 8(6) thereto.

I am not asked to consider the valuation of $4,000.00 placed upon each 1 per cent of the gross royalty interest, but merely the question as to whether anything should be allowed under this claim. Counsel for the appellant submits that the present value of the gross royalty was an expense of drilling the well; that the granting of the royalty or of the obligation to pay that royalty represented something additional which the appellant agreed to pay or grant in order to secure the advances from Wartime Oils to drill the well.

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The short answer to this submission so far as Well No. 20 is concerned is that the appellant never became liable to provide for or pay any royalty to Wartime Oils. The provision for the royalty was merely a contingency which might arise but did not in fact arise at all for the reason that Wartime Oils was entitled to it only if the well or its companion well proved productive, an event which did not occur. It never was and could never become an expense of drilling or prospecting. The situation in regard to the $1,000.00 claimed in regard to Well No. 18 is somewhat different, for while it proved unproductive, its companion well did come into production and for that reason Wartime Oils might conceivably at some time be entitled to $\frac{1}{4}$ of 1 per cent royalty. It is quite problematical as to whether it eventually would receive anything therefrom or become entitled thereto for its right to receive it would not arise until all operational expenses had been met, the full amount of the advances repaid and other prior charges met; the well might be exhausted prior to that time. In any event, there is no evidence that Wartime Oils ever became the owner of any royalty rights therein or were ever paid anything in regard thereto. For that reason it cannot be said that the bookkeeping entry made by the appellant was at any time up to December 31, 1946, an expense which the appellant had incurred in its drilling or exploration operations. These claims must also be rejected.

A further defence was raised by the respondent, namely, that there is no right of appeal from an assessment to nil dollars. In this case the appellant was originally assessed for $1,000.00; it served a Notice of Objection and thereafter the Minister, upon reconsideration, reassessed the appellant at nil dollars. In view of the conclusions I have reached on the merits of the case, it becomes unnecessary to consider this submission.

The appeal will accordingly be dismissed and the assessment affirmed. The respondent is entitled to be paid his costs after taxation.

Judgment accordingly.