

BETWEEN:

CLARENCE E. SNYDER..... APPELLANT;

AND

MINISTER OF NATIONAL REVENUE.. RESPONDENT.

AND

WILLIAM E. APPEGATE..... APPELLANT;

AND

MINISTER OF NATIONAL REVENUE.. RESPONDENT.

1937
Sept. 20.

1938
Aug. 27.

Revenue—Income tax—Proceeds from production of oil well charged with payment of cost of drilling paid to contractor upon instructions of person entitled to proceeds—Income—Liability for tax.

Appellants, sub-lessees of Sterling Pacific Oil Company Ltd., were granted a licence, subject to certain conditions, to drill an oil well on certain land in the Province of Alberta, and to operate the same. Appellants assigned this lease to Sterling Royalties, Ltd., which undertook to perform the conditions of the original lease and to drill the well,

1938

CLARENCE E.
SNYDER
v.
MINISTER OF
NATIONAL
REVENUE
AND
W. E.
APPLEGATE
v.
MINISTER OF
NATIONAL
REVENUE.
—
Maclean J.

paying therefor by the sale of units of production to the public, and to transfer to appellants the remaining units of production. In pursuance of this agreement, Sterling Royalties, Ltd., entered into an agreement with one, Head, to drill the well, and to pay him therefor in accordance with the terms of the agreement.

Sterling Royalties, Ltd., failed to sell sufficient units of production to pay the full contract price to Head for completion of the well. The remaining units of production were transferred to appellants who agreed that those units of production should be charged with the payment of the balance of Head's contract price, contingent upon the well being a producing one, and which units of production were pooled by appellants for that purpose. The well was completed and the sum of \$16,333 50 paid by Sterling Royalties, Ltd., to Head. The amount was deducted from the proceeds derived from the pooled units of production.

The Commissioner of Income Tax assessed this amount of \$16,333.50 for income tax purposes, the assessment being confirmed by the Minister of National Revenue. The appellants appealed.

Held: That the payment to Head by Sterling Royalties, Ltd., on instructions of appellants, was a payment made at the request of appellants out of income, and appellants are liable for the tax.

APPEALS, under the provisions of the Income War Tax Act, from the decision of the Minister of National Revenue.

The appeals were heard before the Honourable Mr. Justice Maclean, President of the Court, at Calgary, Alberta.

H. S. Patterson, K.C. and *A. W. Hobbs* for appellants.

C. J. Ford, K.C. and *J. R. Tolmie* for respondent.

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

THE PRESIDENT, now (August 27, 1938) delivered the following judgment:

These appeals from the decision of the Minister of National Revenue affirming assessments for income tax levied against the appellants, for the year 1934, were heard together, but evidence was heard in the case of the appellant Snyder only. Paragraphs 3, 4, 5 and 7 of the statement of claim were abandoned at the trial.

On June 1, 1933, the appellants Snyder and Applegate, and one Wilkinson (hereafter referred to as "the appellants"), entered into an agreement with Sterling Pacific Oil Company Ltd. (hereafter to be called "Pacific Oil Company") whereby the former were granted a licence, which I shall refer to as a "lease," to drill one oil well on certain lands in the Province of Alberta, to operate the

same, and to dispose of any petroleum products and gas if recovered therefrom in commercial quantities, upon the covenants, conditions and stipulations, in said agreement set forth. I might here add that one Elves later became associated with the appellants in the undertaking. The Pacific Oil Company leased the said lands from The Calgary & Edmonton Corporation Ltd., here called "the Head Lessor," the latter corporation being the successor in title, by lease, to The Calgary & Edmonton Land Company Ltd., and which lease is hereinafter referred to as "the Head Lease." It was a term of the lease from Pacific Oil Company to the appellants that the latter should pay to the former "a royalty in cash" of one-eighth of the current market value at the time and place of production of all the oil and gas produced and saved from the leasehold, this being the royalty payable by Pacific Oil Company to the Head Lessor, and similarly a royalty in cash of one-tenth of all the oil and gas produced and saved, to Pacific Oil Company. The first mentioned royalty was to be paid to the designated agents of the Head Lessor, and the second mentioned royalty to Pacific Oil Company.

In several agreements put in evidence, the terms "royalties" and "units of production" seem to be employed synonymously as denoting a share in the production of the oil well to be drilled, each unit being one per cent of production. I do not think it is correct here to use interchangeably the words "royalties" and "units of production." In the lease from Pacific Oil Company to the appellants the latter obligated themselves to pay to the former, and the Head Lessor, a "royalty in cash" representing certain proportions of the market value of "all" the oil or gas produced or saved from the leased area, and that means the gross amount of oil or gas produced or saved. There, the term "royalty" is, I think, appropriately used and it means that fixed proportions of the value of the gross production were to go to Pacific Oil Company, and the Head Lessor, and they are the equivalent of rents for the leased area. In another agreement, to which I shall presently refer in some detail, between the appellants and Sterling Royalties Ltd., reference is made to the sale of "royalties or units of production." In practice, I should think that when one speaks of the sale of "units of pro-

1938
 CLARENCE E.
 SNYDER
 v.
 MINISTER OF
 NATIONAL
 REVENUE
 AND
 W. E.
 APPELLEGATE
 v.
 MINISTER OF
 NATIONAL
 REVENUE,
 Maclean J

1938
 CLARENCE E.
 SNYDER
 v.
 MINISTER OF
 NATIONAL
 REVENUE
 AND
 W. E.
 APPLGATE
 v.
 MINISTER OF
 NATIONAL
 REVENUE.
 Maclean J.

duction " it means the sale of a right to participate in the production of an oil well, after the distribution of any royalties payable out of gross production; and, I assume, after payment of all costs of production; in reality it means the right of unit-holders to participate in the net production of an operating company, in the proportion in which they each hold units of production in the operating company, or otherwise as determined. In such cases the obligation of the operating company might be fulfilled by delivery over of oil itself, in barrels or in the unit of measure in which it is quoted, sold and delivered, in the market. Now that, I think, is something different from a "royalty." In practice, I assume the production is sold at the current market price, and what is paid over or divided is the proceeds of such sales. I think there is a distinction between a "royalty" and a "unit of production," in this case at least, and while possibly this distinction is not of very great consequence yet it will perhaps assist in a correct understanding of the exact state of facts here.

The lease from Pacific Oil Company to the appellants was, on June 1, 1933, with the consent of Pacific Oil Company, assigned by the appellants to Sterling Royalties Ltd., which company agreed to assume and carry out all the covenants and obligations of the appellants under their agreement with Pacific Oil Company, and in consideration of such assignment the appellants were to receive 3,450 fully paid shares in the capital stock of Sterling Royalties Ltd. to be divided among Wilkinson, Snyder, Applegate and Elves, in the proportions mentioned in the written instrument assigning the lease. This agreement provided:

It is understood that the Party of the Second Part (Sterling Royalties Ltd) will proceed forthwith to sell sufficient royalties or units of production for such an amount and in such manner and on such terms and conditions as will secure the drilling of a well on the property hereinbefore mentioned, according to the terms of the said agreement. It being agreed between the parties hereto and the Parties of the First Part as between themselves hereby agreeing, that after the sale of sufficient royalties or units of production as aforesaid, the royalties or percentages of production remaining shall be divided among the Parties of the First Part and Fred, Elves in the proportion to the shares held by each in the Company as hereinbefore set out; said royalties to be considered as part of the consideration for the sale, transfer and assignment of the said contract as hereinbefore set out. The Company holding the lease, drilling the

well and operating the same for such consideration as may be agreed upon between the Company and a Trustee for the unit holders.

It is further understood and agreed that the remaining royalties above mentioned and hereby agreed to be transferred to the Parties of the First Part and Fred. Elves, or the proceeds therefrom shall bear certain costs and charges mutually agreed upon between the Parties of the First Part and Fred. Elves, including the sum of Fifteen thousand (\$15,000) Dollars, part of the price of drilling the well which it is proposed to pay to Hilary H. Head, drilling contractor, from production in an agreement now being negotiated with him.

From the last recited paragraph of the agreement, it will be seen that after selling such units of production as would secure the drilling of the well—and after payment of the “royalties” of course—the remaining units of production were to be transferred to the appellants, and that the remaining units of production so transferred, or the proceeds therefrom, should bear certain “costs and charges,” including that part of the cost of drilling the well which was to be paid from production. At the date of this agreement negotiations were under way with one Hilary H. Head to drill the well, and, as will shortly appear, a portion of the cost of drilling the well was to be paid from production.

An agreement between Head and Sterling Royalties Ld. was subsequently entered into, wherein Head agreed to drill the well according to the terms and conditions therein set forth, for which he was to receive as consideration therefor the sum of \$30,000, one-half of which, \$15,000, was to be paid in cash in monthly instalments, and as to the balance the agreement provided:

The remaining balance, namely, Fifteen thousand (\$15,000) Dollars, is to be paid out of the sale of production at the rate of Two thousand (\$2,000) Dollars per month, but not to exceed forty per cent (40%) of the net production coming to the Owner after the payment of all royalties in connection with the said wells.

In passing I might observe that in this recited paragraph a distinction is apparently made between the sale of “production” and the payment of “royalties.” The agreement also provided that if Head were successful in placing eight-inch casing at the depth of five thousand feet, as in the agreement specified, he should receive a bonus of \$2,500, also payable from production. This is not, I think, of any special significance in respect of the issue to be determined.

1938
 CLARENCE E
 SNYDER
 v.
 MINISTER OF
 NATIONAL
 REVENUE
 AND
 W. E.
 APPELATE
 v.
 MINISTER OF
 NATIONAL
 REVENUE.
 Maclean J.

1938

CLARENCE E. SNYDER
 v.
 MINISTER OF NATIONAL REVENUE
 AND
 W. E. APPLIGATE
 v.
 MINISTER OF NATIONAL REVENUE.
 ———
 Maclean J.

The Trusts and Guarantee Company Ltd. was selected as a Trustee, and in an agreement between Sterling Royalties Ltd. and the Trustee, dated June 24, 1933, the former agreed to pay to the Trustee for the holders or purchasers of royalties or percentages or units of production, a royalty in cash at the current market value at the time and place of production of all the petroleum, natural gas, gasoline gas and petroleum products, recovered from the well during the unexpired residue of the term of years of the lease, and every renewal thereof, and the agreement states that the same were to be " . . . subject to the payment of Twelve and one-half (12½%) per cent. of the gross production to The Calgary and Edmonton Land Corporation Ltd.; Twelve and one-half (12½%) per cent. of the gross production to the Sterling Pacific Oil Company Ltd.; Eight (8%) per cent. of the gross production to the Northwest Company Ltd. and all costs and expenses necessary for taking care of the production obtained from the said well, such payments to be made on or before the 20th day of the month next following the month for which the said royalty or production is payable. Such payment to represent Sixty-seven (67%) per cent. of production after deducting expenses and costs of producing the well." I am unable to explain the introduction of the Northwest Company Ltd. but I assume that is capable of easy explanation.

In February, 1934, an agreement was entered into between the appellants, the Parties of the First Part, and Sterling Royalties Ltd. the Party of the Second Part. At this date it appears that the well had been brought into production, certain units of production had been sold from which Head had been paid the first instalment of his contract price, and the remaining units or percentages of production had been transferred to the appellants. This agreement recites that under the agreement of June 1, 1933, between the same parties, it was agreed that after the sale of sufficient royalties to secure the drilling of the well, the remaining royalties or units of production were to be divided among the appellants as part of the consideration for their assignment of the lease to Sterling Royalties Ltd.; and that it was agreed that certain costs and charges now amounting to approximately \$20,000—but which turned

to be \$16,333.50—should be borne by the appellants, which was included the sum of \$15,000 which was to be to Head out of production. The agreement then proceeds:

The Parties of the First Part hereby agree to pool their royalties percentages of production for the purpose of paying all costs, charges expenses agreed to be paid by them and amounting to approximately ten thousand (\$20,000) Dollars, the details and items of which said amount are well known to each of the Parties of the First Part, and the bonus of Fifteen thousand (\$15,000) Dollars payable to Hilary Head under a drilling agreement with him dated 7th June, 1933

The Parties of the First Part further agree to pool the proceeds of said royalties or percentages of production for the purpose of paying the said costs and charges.

That the proceeds derived from the said royalties be paid to the Parties of the Second Part for the purpose of paying the said costs and charges as hereinbefore set out

That the production of this agreement, or a copy thereof, to The Trustee and Guarantee Company Limited, shall be sufficient warrant and authority for that company to pay to the Parties of the Second Part the proceeds of the said royalties held by the Parties of the First Part as hereinbefore agreed, and for the purpose herein set forth; this agreement shall remain in full force and effect until all the said costs and charges aforesaid have been paid in full and until this agreement is determined and discharged by a majority vote of the shares held by the Parties of the First Part in the Parties of the Second Part.

This agreement, it will be perceived, provides for a pooling of the remaining units of production, which, it is agreed, have been allotted and transferred to the appellants, for the purpose of liquidating the indebtedness due Head for drill—namely, \$16,333.50, and which amount was a charge on such “remaining units or percentages of production” which came, or were coming, to the appellants; and the agreement authorized the Trustee to pay to Sterling Royalties Ltd., from the proceeds of such pooled units of production, sufficient to liquidate the indebtedness to Head, that is to say, the “costs, charges and expenses” which the appellants had agreed to pay. Whether the full amount of \$16,333.50 was payable to Head, or whether a portion of it was payable to other creditors, is not clear, but apparently nothing turns upon that.

Now what emerges from all this? The appellants acquired the leased area from Pacific Oil Company. They engaged themselves to drill a well thereon. Then the appellants assigned the lease to Sterling Royalties Ltd. The latter undertook to drill the well, to sell sufficient units of production for securing the necessary amount of capital

1938

CLARENCE E.
SNYDERv.
MINISTER OF
NATIONAL
REVENUEAND
W. E.
APPELLEGATEv.
MINISTER OF
NATIONAL
REVENUE.

Maclean J.

1938
 CLARENCE E.
 SNYDER
 v.
 MINISTER OF
 NATIONAL
 REVENUE
 AND
 W. E.
 APPELGATE
 v.
 MINISTER OF
 NATIONAL
 REVENUE.
 Maclean J.

to pay for the drilling of the well, to pay over to the Head Lessor and others certain stated royalties, and to transfer to the appellants the remaining units of production. The undertaking was to be financed from the sale of units of production and not from the sale of shares in Sterling Royalties Ltd., and any profits and gains derived from the undertaking were to be distributed among the holders of units of production as their several interests would appear. Sterling Royalties Ltd., which was controlled if not wholly owned by the appellants, did not sell the requisite number of units of production wherefrom to pay Head his full contract price for drilling the well. It is to be inferred from the evidence that, after Head was paid in cash the first instalment of his contract price, from sales of units of production to the public I assume, the remaining units were transferred to the appellants, amounting it appears to 30½ per cent of the entire units of production. But those units of production were charged with the payment of the second instalment of Head's contract price, the appellants having agreed to pay the same, and which payment was contingent upon production. As payment of the last instalment of Head's contract price was contingent upon production, the transfer of the remaining units to the appellants, subject to a charge for the payment of the said instalment, would seem a convenient arrangement to adopt in the circumstances, in fact some such arrangement was imperative on account of sufficient units of production not having been sold to the public, prior to the transfer of the remaining units to the appellants. After the said transfer Sterling Royalties was without any source of income. But it was only the units of production transferred to the appellants that were made liable for this charge. The appellants were under covenant to Pacific Oil Company to drill the well, and, as the real promoters of the undertaking, they were interested in establishing whether or not the leased area was likely to produce oil or gas in commercial quantities, and if successful in that regard, in making provision for the payment of the second instalment of Head's contract price. Accordingly they agreed that their units of production should be charged with the payment of that portion of Head's contract price. This has every appearance of saying that if the well came into production

the payment of the last instalment of Head's contract price was to be taken from the proceeds derived from the appellants' units of production, that is, from the proceeds or income distributable among the appellants from the sale of any production belonging to them. The appellants therefore having agreed to pay any "costs and charges" becoming due and owing to Head, then believed to be approximately \$20,000, they later agreed with Sterling Royalties Ltd. that their individual units of production so charged should be pooled for the purpose of paying from any proceeds or income therefrom any costs and charges owing Head; and the Trustee was authorized to pay to Sterling Royalties Ltd., from such source, such sum as would liquidate the indebtedness to Head on account of his drilling contract. Such proceeds would therefore come from any net production credited to or distributable among the appellants from the units of production held by them. In the result, the proceeds of the units of production transferred to the appellants, and pooled, were diminished by such an amount as was necessary to pay the balance of Head's claim, and while that portion of such proceeds, amounting to \$16,333.50, never came into the hands of the appellants, yet the same was paid over to Head by Sterling Royalties Ltd., upon the direction of the appellants. Virtually it was a payment made by the appellants. The claim now made on behalf of the Crown is that the appellants are liable for the income tax upon that portion of the proceeds derived from their pooled units of production which was applied in settlement of Head's claim, and which it is asserted was income received by the appellants. The appellants contend that they did not receive all the proceeds of such pooled units of production, but only in a diminished amount, the difference being expressed by the sum of \$16,333.50 paid to Head, and that they should not be taxed therefore on something which they never received.

1938
 CLARENCE E. SNYDER
 v.
 MINISTER OF NATIONAL REVENUE
 AND
 W. E. APPELLEGATE
 v.
 MINISTER OF NATIONAL REVENUE.
 ———
 Maclean J

The point for determination is not free entirely from difficulties, but the contention of the Crown must, I think, prevail. The appellants were the holders of the remaining units of production, and having undertaken that their units of production should bear the "costs and charges" in question they agreed that there should be taken from the proceeds of their pooled production units sufficient to

1938
 CLARENCE E.
 SNYDER
 v.
 MINISTER OF
 NATIONAL
 REVENUE
 AND
 W. E.
 APPLAGATE
 v.
 MINISTER OF
 NATIONAL
 REVENUE
 Maclean J.

pay the claim of Head, which was, I think, a payment made at the request of the appellants out of income coming to them as the holders of their units of production. This was merely saying: "You, Sterling Royalties Ltd., pay out of any proceeds coming to us from our pooled units of production sufficient to pay the balance of Head's contract price for drilling the well." The second instalment of the drilling contract price could only come from the proceeds of the units of production held by the appellants, and not from the units of production held by others, because, as already stated, no further units then remained in the hands of Sterling Royalties Ltd. or the Trustee. It was a part of the consideration for the assignment of the lease to Sterling Royalties Ltd. that the units of production transferred to the appellants should be charged with the payment of the second instalment of Head's contract price, if the well came into production. The source of the payment to Head was in the nature of a dividend, or a profit or gain, earned and distributable to the appellants from their production units, in the proportions in which each held shares in Sterling Royalties Ltd. The payment to Head might be regarded as being in the nature of a capital investment made by the appellants from income derived from their units of production, and which investment the appellants had agreed to make if the well came into production. In effect it increased the equity of the appellants in the undertaking which otherwise would have been less by that number of units of production represented by \$16,333.50. It is not correct therefore, I think, to say that the appellants never received consideration for that which was paid to Head; they received, or there was available for distribution among them, \$16,333.50, as part of their share in earned proceeds of production; but, upon their order that sum was paid over to Head to liquidate a debt due him which increased their equity in the net proceeds of production available for future distribution among unit holders; it, at least, released the charge or encumbrance recorded against their holdings of units of production in the books of the Trustee and restored the full face value of the same, and this was done by the application of their own income received from production. If the requisite number of units to produce \$16,333.50 had been subscribed

for by members of the public any payments made thereon by subscribers could not have been claimed as an allowable deduction in assessing income tax. And the situation is, I think, analogous so far as the appellants are concerned; because they directed that so much of the income payable or distributable to them from their units of production be diverted to Sterling Royalties Ltd. by the Trustee, to liquidate a debt owing to Head by Sterling Royalties Ltd., and which was incurred for capital purposes. The transaction might also be regarded as the purchase from income of Head's right to the proceeds of a certain amount of production. The appellants purchased from Head, his right to certain proceeds of production, from their own income, so as to avoid the sale of any of their units of production to the public. The amount owing Head on the second instalment of his contract price was to come from the sale of production, it was payable contingent upon production, and the appellants agreed from the first that, if production came, their units of production, that means any proceeds or income derived therefrom, would stand charged with the payment of that amount. If payment of that portion of Head's contract price is not to be treated as purely an obligation of the appellants then, it seems to me, the public which had purchased other units would be unfairly treated because it was not their obligation to pay any part of this debt from the proceeds of their production units; this, I think, the appellants never contemplated because they plainly agreed that any amount owing Head on account of the second instalment of his contract price would be charged only against their right to any income distributable from production.

The income from which Head's claim was paid came directly from the sale of production belonging to the appellants, which, it seems to me, is just the same as if it came from any other income which they might have received and possessed. Whatever the form which the payment to Head took, the source of the payment must, I think, be treated as the income of the appellants, as in substance, I think it was. That being so I do not think it was a disbursement for which any deduction may properly be claimed. The appeal is therefore dismissed. In all the circumstances here I do not think there should be any order as to costs.

Judgment accordingly.

1938

CLARENCE E.
SNYDERv.
MINISTER OF
NATIONAL
REVENUEAND
W. E.
APPLEGATEv.
MINISTER OF
NATIONAL
REVENUE.

Maclean J.