1959

*Jun. 17, 18
Nov. 30

WESTERN MINERALS LIMITED .....APPELLANT;

AND

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

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Taxation—Income tax—Capital gain or income—Company—Powers under memorandum of assosiation—Money received under oil leasing agreement—The Income Tax Act, 1948(Can.), c. 52, ss. 3, 4.

In 1944, the appellant company and Western Leaseholds Ltd. (see *ante* p. 10) were incorporated and were at all relevant times owned and controlled by the same shareholders and directors. The declared objects of each company included, *inter alia*, the carrying on of the business of drilling for, producing and marketing oil, and the acquiring by purchase, lease, concession or licence mineral properties or any interest therein and selling and disposing of or otherwise dealing with the same or any interest therein. The appellant acquired the freehold mineral rights in some 496,000 acres, and Western Leaseholds Ltd. acquired the right to lease or sublease these rights on a 10 per cent. royalty basis.

In 1950, the appellant company, at the request of Western Leaseholds Ltd., leased certain acreage to Imperial Oil Ltd. on a 9 per cent. royalty basis. The money for the lease was paid by Imperial Oil Ltd. to Western Leaseholds Ltd., which in turn paid to the appellant

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

in the years 1949 and 1950 a sum of over $234,000. The Minister treated this amount as taxable income, and this assessment was upheld by the Exchequer Court.

Held: The money in question was taxable income.

Western Leaseholds Ltd. was under no liability to pay any royalty to the appellant except in respect of leases granted to it. It was under no legal obligation to pay these moneys. The receipt of these moneys by the appellant should be treated as moneys paid to it in the ordinary course of its business of dealing in mineral rights with a view to profit, and as such, part of its income for the purposes of taxation. Even if Western Leaseholds Ltd. had been under any legal liability for the payment of royalty in respect of the mineral rights leased in this case, the moneys received formed part of the appellant's taxable income.

APPEAL from a judgment of Cameron J. of the Exchequer Court of Canada[1], affirming an assessment made by the Minister of National Revenue. Appeal dismissed.

A. S. Pattillo, Q.C., and *J. B. Tinker*, for the appellant.

D. W. Mundel, Q.C., *A. L. DeWolf* and *K. E. Eaton*, for the Respondent.

The judgment of the Court was delivered by

LOCKE J.:—This is an appeal from a judgment of Cameron J. delivered in the Exchequer Court[1] which dismissed the appeal of this appellant from assessments under *The Income Tax Act* for the taxation years 1949 and 1950. By the consent of the parties the evidence given on an appeal by Western Leaseholds Limited (referred to hereafter as "Leaseholds") before the Exchequer Court was made applicable to the present matter and the judgment delivered by Cameron J. disposed of both appeals[1].

In the reasons for judgment in the case of Leaseholds which will be delivered contemporaneously with the giving of judgment in the present matter I have stated at length the facts concerning the incorporation of these two companies, both of which were incorporated at the instance of Mr. Eric L. Harvie, a barrister practising in Calgary. I refer to the facts as there stated without repeating them.

The present appeal concerns the liability of the appellant to taxation on a sum of $34,850.13 received by it in the year 1949 from Leaseholds and a further sum of $199,544.55 from that company in 1950.

[1] [1958] Ex. C.R. 277, [1958] C.T.C. 257, 58 D.T.C. 1128.

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It is the contention of the appellant that these two amounts represent moneys received from the realization of what was a capital asset in its hands, that asset being what is said to have been a right to be paid a royalty by Leaseholds of 10 per cent. of the value of the production of petroleum in the area in which the mineral rights were leased to Imperial Oil Company. The respondent contends that these are simply moneys realized in the course of the carrying on of the appellant's business of dealing in the mineral rights acquired by it in 1944 with a view to profit.

The evidence is by no means clear as to the true nature of the consideration for the making of these payments by Leaseholds.

In the balance sheet of the appellant for the year 1949 prepared by its auditors and filed with the income tax return there appeared an entry which read:

Realization from the sale of a royalty interest .....$ 34,850.00

This was treated as a capital gain by the auditors. For the year 1950 the balance sheet showed a like entry with the amount of realization stated at $234,395. There are deductions from the latter amount which reduced the amount in question for the year 1950 to that first above stated.

The Minister, in making his assessment for these years, treated the amounts as business receipts of the company for the purpose of computing its taxable income.

The appellant filed notices of objection to the disallowance of its claim that these were receipts from the realization of a capital asset and these notices form part of the record. The objection to the assessment for the year 1949 claimed that pursuant to the agreement made by the appellant with Leaseholds on December 31, 1947, whereby it had granted to that company the right "to purchase up to 7% of the said 10% gross royalty on the lands included under the Imperial Oil option" at the prices stated, Leaseholds had purchased 6 per cent. of the aforesaid gross royalty at a purchase price of $34,850.13 calculated in accordance with the aforesaid agreement. The reason for the purchase was stated to be that as the royalty payable by Imperial Oil under the option exercised in that year was merely 4 per

cent. and since "Western Leaseholds, in turn, was required to pay a 10% gross royalty to the taxpayer, the purchase had been necessary."

In respect to the year 1950, the objection stated that when the Imperial Oil Company exercised its option in 1950 in respect of 190,929.29 acres it had been agreed between Leaseholds and Minerals that the latter should grant a lease direct to Imperial Oil reserving a 9 per cent. royalty. As this was 1 per cent. less than Leaseholds was required to pay under the option it held from the appellant, Leaseholds was required to account to the appellant for the 1 per cent. difference which it did

by buying a 1% gross royalty from the Apellant at the price for royalty above set out, being $199,544.55 (after an adjustment to a payment received in 1949 by the Appellant in connection with the same transaction).

In the Agreement for Leases dated July 7, 1944, made between the appellant and Leaseholds, the appellant granted to the former company:

. . . the sole and exclusive right to acquire a lease and/or leases of the said minerals in the form and upon the terms and conditions included in the draft lease attached hereto as Schedule "B", and subject to the terms and conditions hereinafter set forth.

The Owner will grant the Operator a lease or leases covering any or all of the said minerals in respect to any or all of the said lands as may be from time to time requested by the Operator.

* * *

IT IS UNDERSTOOD AND AGREED that the Operator shall be entitled to operate the said leases on its own behalf or may at its sole election grant subleases in respect to any or all of the said minerals . . . .

The draft lease which formed Schedule "B" to the agreement was expressed to be between Minerals as lessor and Leaseholds as lessee: the consideration expressed was the sum of $1, and in addition it was provided:

. . . that the Operator shall and will pay a royalty in cash of 10% of the current market value at the time and place of production of all leased substances produced, saved and sold from the said leased lands.

As the evidence disclosed, the option dated May 15, 1946, which was given to the Shell Oil Company was an option to purchase in fee the mineral rights, and Minerals, as the owner, of necessity joined as a party in giving it. While that option was dropped and nothing further paid by the

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optionee, the option granted, if exercised, required a payment of a fixed sum per acre and in addition a royalty which increased from year to year during the term of the option varying from 2½ per cent. to 6½ per cent. No lease of the area was then granted to Leaseholds and accordingly no royalty would have become payable by it under the agreement of July 7, 1944, if production of oil had been obtained. The parties however, by an agreement made contemporaneously with the granting of the option to the Shell Company which recited that the companies considered that it was in their mutual interests to grant the option, agreed that in the event that Shell purchased any of the mineral rights, Minerals would accept $2 per acre as settlement for its interest in the rights so purchased. It does not appear that it occurred to Mr. Harvie and his associates who directed the policy of both companies that under this option, if exercised, any liability for royalty would attach to Leaseholds in respect of any production obtained.

When the Imperial Oil option was given on February 7, 1947, it gave to the optionee the right to acquire the fee in the mineral rights in consideration of a fixed price per acre and a royalty which varied from 3 per cent. to 7 per cent. dependent upon the year in which the option was exercised. On December 31, 1947, after the Imperial Oil Company had paid the $250,000 as payment for the option for five years, Leaseholds wrote a letter addressed to Minerals which was approved by the latter, which, after referring to the option granted, said in part:

> You agree that we are entitled to retain the sum of $250,000 option money paid by Imperial and are under no liability to account to you in respect thereof.
>
> Under our Lease with you, you are entitled to a 10% royalty, but under the Imperial Option the royalty reserved graduates from 3% to 7%, depending on the year of purchase, and you hereby grant us the exclusive option of purchasing from time to time up to 7% of your royalty on the following basis:

	Per Acre
On the first 10,000 acres	$2.63 for each 1% purchased.
" " second " "	2.10 for each 1% purchased.
" " third " "	1.58 for each 1% purchased.
" " balance of acreage	1.05 for each 1% purchased.

It is to be noted that this letter states that under Leasehold's lease Minerals was entitled to a 10 per cent. royalty but there was, in respect to these lands, no such lease and no such liability. The liability under the agreement of July 7, 1944, was only in respect of leases granted to Leaseholds. The agreement contained no provision for Minerals granting leases to others, and accordingly there could be no such liability in the case of the option to Imperial Oil which was for the sale of the mineral rights outright or under the lease which was eventually granted unless such liability was imposed by some further agreement made between the parties.

When, however, the Imperial Oil Company had exercised its option and paid the consideration, a further agreement was made between the appellant and Leaseholds dated December 30, 1950, described as an "Agreement of Settlement and Adjustments". The agreement provided, *inter alia,* that the rights of Leaseholds under the agreement of July 7, 1944, were to be terminated on the completion of the arrangements provided for which required Minerals to grant a lease in a form which was made a schedule to the agreement of all of the mineral rights in the area less those in the area in respect of which a lease had been granted on November 1, 1946, to Imperial Oil Limited, referred to as the "Leduc Lease" and the 193,137.79 acres covered by the lease to Imperial Oil dated January 15, 1951. A further term of the agreement was that Leaseholds should be entitled to retain all moneys paid by Imperial Oil Limited "as the purchase price for the said lease" under the terms of the option letter dated February 4, 1947, except the sum of $234,394.68:

> . . . being the amount paid by Leaseholds to Minerals as consideration for reducing the royalty payable under the Agreement for Leases from 10% to 9%, which sum was computed on the basis set forth in letter between the parties hereto dated the 31st day of December, A.D. 1947.

Mr. Harvie, who, through his majority share interest, controlled both companies, gave evidence at the trial, but said nothing about these payments. Mr. Arnold, a director, who was in close touch with the management of both companies during this period, merely produced the letter of December 31, 1947, signed by the parties without comment.

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Mr. H. W. Meech who was secretary of both companies in November 1947 and thereafter simply said that the agreement said that the sum was paid by Leaseholds to Minerals as consideration for reducing the royalty payable under the Agreement for Leases and that the amounts were computed in accordance with the schedule set out in the agreement. The agreement was that dated December 31, 1947.

As the Agreement for Leases dated July 7, 1944, obligated Leaseholds to pay, *inter alia,* a royalty of 10 per cent. of the value of production only upon lands leased to it by Minerals and as the option given to Imperial Oil on February 7, 1947, was for a sale outright of the mineral rights upon defined terms and as, when the option was exercised for the balance of the lands in 1950, a lease of the remaining 190,929.29 acres was, at that company's request, substituted for a conveyance of the mineral rights, Leaseholds was under no liability to pay any amount as royalty to Minerals when that transaction was completed unless some independent agreement was made between them whereby it assumed such liability. As to this it is sufficient to say that there is no evidence of any such agreement. The appellant indeed does not appear to suggest that any such agreement had been made.

It will be seen that the letter of December 31, 1947, above quoted says that "under our lease with you, you are entitled to a 10% royalty", but this is inaccurate. There was no such lease of the area affected by the Imperial Oil option and no liability accordingly under the Agreement for Leases. Similarly the recital in the Agreement of Settlement of December 30, 1950, says that the amount in question was paid as consideration for reducing the royalty payable under the Agreement for Leases when, in truth, no royalty was payable by Leaseholds under that agreement.

The various positions taken by the appellant in regard to the making of these payments has not been consistent. In the notice of objection to the assessment in regard to the payments made in 1949 it was said that the sum of $134,850.13 was paid to purchase 6 per cent. of the gross royalty reserved which presumably meant the royalty payable under the Agreement for Leases. However, for the year 1950, the notice of objection stated that the moneys had

been paid to purchase a 1 per cent. gross royalty from the taxpayer, this apparently referring to the gross royalty payable under the terms of the Imperial Oil option. The settlement agreement, however, says that the moneys were paid as the consideration for reducing the royalty payable by Leaseholds.

In the reasons for judgment delivered by Cameron J. it is said that counsel for Minerals had contended that "in effect, Leaseholds purchased 1% of the Imperial Oil royalty from Minerals". The learned judge rejected this contention since he considered that it was clear that after December 30, 1950, Minerals was entitled to the full royalty of 9 per cent. and Leaseholds to no part of it. He considered that the only reasonable interpretation to put upon that part of the Agreement of Settlement and Adjustments referred to was that Minerals thereby agreed to cancel that part of their contract of July 7, 1944, by the terms of which Leaseholds was bound to pay Minerals 1 per cent. more royalty than Imperial Oil would pay by the terms of the new agreement of December 30, 1950.

I am unable, with great respect, to agree with this conclusion since Leaseholds was under no liability to pay any royalty except in respect of leases granted to it.

The argument addressed to us by counsel for the appellant is that the amount was paid to Minerals and received by it as the consideration for commuting its right to receive the larger royalty which is to adopt the finding made by the learned trial judge. In the absence of any evidence of an agreement imposing such liability, the receipt of these moneys by the appellant should, in my opinion, be treated as moneys paid to it in the ordinary course of its business of dealing in the mineral rights with a view to profit, and as such, part of its income for the purposes of taxation. Once it is shown that Leaseholds was under no legal obligation to pay these amounts, the whole basis of the appellant's argument disappears.

While this is, in my view, fatal to the appeal, I would add that if Leaseholds had been under any legal liability for the payment of royalty in respect of the mineral rights

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acquired by conveyance or lease by Imperial Oil Limited, I would agree with the learned trial judge that the moneys received form part of its taxable income.

The Memorandum of Association of the appellant declared the same objects as those stated in that of Leaseholds. As the learned trial judge has pointed out, the evidence makes it clear that Minerals never intended to go into production on its own account and it could make a profit only by the disposal in one form or another of such mineral rights as it owned. The source of these moneys is not in doubt. They form part of the amounts paid by Imperial Oil Limited—to adopt the language of the Agreement of Settlement of December 30, 1950—as "the purchase price for the said lease". I think it impossible to distinguish receipts of this nature from rents and royalties received under the lease when granted in determining whether they are taxable as income.

I would dismiss this appeal with costs.

Appeal dismissed with costs.

Solicitors for the appellant: Stikeman & Elliott, Montreal.

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