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* Feb. 27, 28.
* June 27.

CLARENCE E. SNYDER .... APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE .... RESPONDENT.

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Revenue—Income tax—Proceeds from production of oil well charged with payment of costs of drilling paid to contractor—Income—Liability for tax.

The appellant, and a group of persons who were sub-lessees of Sterling Pacific Oil Company Limited, 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. The appellant and his associates assigned this licence and their rights to Sterling Royalties, Ltd., which undertook to perform the conditions of the original lease and to drill the well, paying therefor by the sale of units of production to the public, and to transfer to appellant and associates the remaining units of production. The Sterling Royalties Ltd. then entered into an agreement with one, Head, to drill the well for a sum of $30,000, $15,000 payable in cash and $15,000 to be paid by the company out of the sale of production. The remaining units of production were

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transferred to the appellant and associates, who agreed that those units, having been pooled for that purpose, should be charged with the payment of the balance of Head's contract price. The well was completed, and the sum of $16,333.50 was paid by Sterling Royalties Ltd. to Head, and the amount was deducted from the proceeds derived from the pooled units of production. The Commissioner of Income Tax assessed that amount for income tax purposes, the assessment being confirmed by the Minister of National Revenue. The appellant then appealed to the Exchequer Court of Canada, which held that the payment to Head by Sterling Royalties, Ltd., was a payment made at the request of appellant and associates out of income, and that the appellant was liable for income tax in respect of his portion of $16,333.50.

Held, reversing the judgment of the Exchequer Court of Canada ([1938] Ex. C.R. 235), Crocket and Hudson JJ. dissenting, that, in view of the deeds and written agreements filed at the trial and of the other circumstances of this case, the above sum of $16,333.50 was never, directly or indirectly, received by the appellant and his associates within the meaning of the *Income War Tax Act* and cannot properly be treated as taxable income.

APPEAL from the judgment of the Exchequer Court of Canada, Maclean J. (1), dismissing the appeal of the appellant against the assessment of the Honourable Minister of National Revenue of the sum of $16,333.50 as having been received by the appellant and his associates from Sterling Royalties Ltd., as income from the oil well operated by that company during the taxation year 1934.

The material facts of the case and the questions at issue are fully stated in the above head-note and in the judgments now reported.

H. S. Patterson K.C. for the appellant.

Clinton J. Ford K.C. and *J. R. Tolmie* for the respondent.

THE CHIEF JUSTICE.—The controversy on this appeal turns upon the provisions of certain agreements which I proceed to consider.

The appellant is one of a group, to whom I shall refer as the vendors, and who had a licence from the Sterling Pacific Oil Company (to which I shall refer as the licensors) who, in turn, were lessees, under a lease from the Calgary and Edmonton Corporation, of the petroleum and natural gas in a tract of land, a part of the Calgary and Edmonton

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Railway Company's land grant. This last mentioned lease will be referred to as the Head lease and the lessors as the Head lessors.

This lease is dated the 30th of June, 1928, and the licence to the vendors the 1st of June, 1933. The royalty payable under the Head lease is one-eighth, or $12\frac{1}{2}\%$, of the gross production of petroleum and natural gas and, under the license, in the events that have occurred, the same.

On the 1st of June, 1933, the vendors assigned to the Sterling Royalties, Ltd. (which will be referred to as the Company), its licence and its rights under the agreement with the licensors and the Company agreed to assume all the liabilities of the vendors under their agreement with the licensors.

The vendors received, in part consideration of the transfer, 3,450 fully paid up shares of the capital stock of the Company. The agreement contains two important provisions which are in these words:

> 5. It is understood that the Party of the Second Part (that is to say, the Company) 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 or 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.
>
> 6. 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 ($15,000.00) 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.

It is important to notice that the stipulation set forth in the last paragraph (paragraph 6) is that the units of production agreed to be transferred to the vendors and Fred Elves, which will hereafter be referred to as vendors'

units, or the proceeds therefrom, are to bear the costs and charges mentioned and that what these costs and charges are has been mutually agreed upon by the vendors and Fred Elves, and that they are to include the $15,000 mentioned. The important point is that there is no stipulation making the vendors personally responsible for the payment of any of these costs and charges.

Further, this may be a convenient place at which to observe that, nowhere in these instruments is there to be found any evidence of an obligation on the part of the vendors to pay moneys agreed to be paid by the Company to Head for the construction of the well. The vendors were under an obligation to the licensors to construct the well and work it. If they failed to perform that obligation they would expose themselves to an action for damages; but, on the other hand, the Company agreed with the vendors to perform that obligation and also, as we shall see, covenanted directly with the licensors to perform it.

Before proceeding further, it is, perhaps, well to call attention to the manner in which the terms "unit of production" is used by the parties. That appears from the agreement between the Company and the Trustee contemplated by the first of the paragraphs just quoted, which is dated the 24th of June, 1933, some three weeks after the transfer of the licence by the vendors. That agreement recites the lease from the Calgary and Edmonton Corporation to the licensors, the agreement between the licensors and the vendors of the 1st of June, 1933, the transfer of this agreement by the vendors to the Company, and a further agreement between the Company and the North West Company, Ltd., by which the Company had acquired certain necessary equipment of the value of $24,000 in return for a right to eight per cent of the gross production of petroleum and natural gas from the Company's land.

The royalties ($12\frac{1}{2}\%$) due to the Calgary and Edmonton Corporation, and to the licensors respectively, and that due to the North West Company (8%), amounting in the aggregate to 33% of the gross production of petroleum and natural gas, the residue of such production amounted

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to 67%, and the agreement recites that the Company proposes to sell all or part of that "67% in the form of 67 units of production on a net basis (viz., after the payment of the costs of production) for the purpose of financing and drilling a well" on the property. This agreement also recites that "the Company has let the contract for the drilling of the said well and has actually commenced drilling operations."

The provisions of the agreement between the Company and the Trustee make it plain that the rights of the holders of the units of production are, as this recital declares, rights subject to the payment of operating expenses including the cost of drilling the well.

It is necessary to understand clearly what it is that the Trustee gets under this agreement. The Company agrees with the Trustee

to pay or cause to be paid to the Trustee for the holders or purchasers of * * * units of production * * * a royalty in cash at the current market value at the time and place of production of all the petroleum and natural gas * * * recovered from the well now being drilled on the following land (a description of the land follows) during the unexpired residue of the term of years covered by the lease or licence hereinbefore referred to and every renewal thereof

which is to be paid to the Trustee. But this royalty in cash, ascertained as provided for, is subject to the payment, first, of the royalties as above mentioned, amounting in all to 33% of the gross production; and, second, "all costs and expenses necessary for taking care of the production obtained from the said well." Then follows this most important stipulation,

Such payment to represent sixty-seven (67%) per cent of production after deducting expenses and costs of producing the well.

There are two further provisions of the agreement which it is necessary to notice. The first is sub-paragraph (*c*) of paragraph 1, by which the Company covenants with the Trustee

that it will regularly and duly pay from production all expenses and costs of producing the well and . . . with the said well.

The second is sub-paragraph (*h*). In virtue of this paragraph, the Company covenants with the Trustee:

(*h*) That the parties entitled to the Sixty-seven (67%) per cent or Sixty-seven (67) units of net production, as hereinbefore mentioned and after the payment of Twelve and one-half (12½%) per cent gross royalty to The Calgary and Edmonton Land Corporation Limited: Twelve and

one-half ($12\frac{1}{2}$%) per cent gross royalty to Sterling Pacific Oil Company Limited and Eight (8%) per cent gross royalty to the Northwest Company Limited, and all expenses and costs of producing the said well, and the percentage or amount of net production or units on a net production basis, to which they are entitled, are as follows:

Name	Address	Royalty or Unit of Production
Fred A. Elves	118 7th Ave. West, Calgary	½ Unit
Robert Wilkinson	118 7th Ave. West, Calgary	½ Unit
Clarence Snyder	118 7th Ave. West, Calgary	½ Unit
W. S. Applegate	118 7th Ave. West, Calgary	½ Unit
William Anderson	Calgary Power Co., Calgary	½ Unit
D. Chas. Jones	Druggist, Vulcan, Alta	½ Unit
Mary Stack	c/o L. H. Stack, Vulcan, Alta	1 Unit
Fred A. Elves	117 7th Ave. West, Calgary	2 Units
(Issue in 4 Certificates of ½ Unit or ½% of production each)		
Reuben L. Elves	Vulcan, Alberta	1 Unit
A. C. Hogarth	Stock Exchange, Calgary	1 Unit
Herbert Gillies	W. R. Hull Ltd., Calgary	1 Unit
Mrs. W. H. Cawston	616 Elbow Drive, Calgary	1 Unit
P. M. Spence	Stock Exchange, Calgary	1 Unit
Vulcan Oils Ltd	Vulcan, Alberta	13 Units
(Issue in 13 Certificates of 1 Unit or 1% production each)		
Sterling Royalties Ltd.	Calgary, Alberta	43 Units

It will be observed that the rights to which the holders of units of production are entitled are described as in sub-paragraph (*h*) as "units of net production as hereinbefore mentioned and after the payment of" the gross royalties to the Head lessor, to the licensors and to the North West Company "and all expenses and costs of producing the said well"; and as "net production or units on a net production basis."

There is still another provision to be noticed and that is sub-paragraph (*i*) of paragraph 1 by force of which the Company covenants that,

(*i*) *Costs and expenses to be deducted from the Sixty-seven (67%) per cent of production or Sixty-seven (67) units of production as herein set out shall be all costs, charges and disbursements in connection with the producing of the well and obtaining production therefrom, after the well has been brought into production,* and in particular shall include the cost or price of production equipment such as storage tanks, separators, pump lines, boilers, pumps, meters, gauges, and all other appliances incidental to profitable production of the said well and installing, setting up and equipping the same, also insurance, taxes, rates, assessments nor/or

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hereafter levied, labour, and a reasonable charge for management, also including the cost of marketing in the event of the Operator being unable to sell the production wholesale.

And now it is necessary to refer to the form of the Trust certificate. These certificates are provided for in paragraph 2 of the agreement and, by that paragraph, they are to be substantially in the form attached. That form is as follows:

This certifies that......................of........................ in the Province of................. is registered on the records of The Trusts and Guarantee Company, Limited, as being entitled to a Royalty of.........per centum (..........%) of all petroleum, natural gas, gasoline gas, naphtha and/or other petroleum products produced and marketed from the first and present well being drilled by Sterling Royalties, Limited, a company incorporated under Companies Act, 1929, of the Province of Alberta, on the following lands, namely:

Legal Subdivision One (1), of Section Thirty-three (33), in Township Eighteen (18), Range Two (2), West of the Fifth (5th) Meridian, in the Province of Alberta,

held by Sterling Royalties, Limited, subject to all the provisions and conditions of the Trust Agreement dated the 24th day of June, A.D. 1933, made between Sterling Royalties, Limited, as Operator, of the First Part, and The Trusts and Guarantee Company, Limited, as the Trustee, of the Second Part, which said Agreement may be inspected during office hours at the office of the said The Trusts and Guarantee Company, Limited, at Calgary, Alberta.

* * *

It will be observed that the "royalty" is a percentage of the natural gas and petroleum produced and marketed from the first and present well being drilled by Sterling Royalties, Ltd., and the holder's right is declared to be subject to all the provisions and conditions of the Trust agreement.

There are still two other agreements at which we must look: first, that of the 2nd of June, 1933, to which the vendors, the licensors and the Company are all parties. The licensors consent to the assignment of the licence from the vendors to the Company, but the two stipulations which should be carefully noticed are contained in paragraphs 2 and 3 which are in these words:

2. The Licensees jointly and severally and the Assignee hereby agree that they, and each of them, will observe, carry out and perform all the obligations contained in the agreement made between the Licensor and the Licensees dated June 1st, 1933.

3. The Assignee hereby covenants and agrees with the Licensor that the Licensor shall have as against the Assignee all the rights and remedies granted by the original agreement dated June 1st, 1933.

As already mentioned, one of the undertakings for which the vendors made themselves responsible to the licensors under their agreement was that the vendors should, within five weeks from the date of the agreement, that is, the 1st of June, 1933, commence the work of drilling a well and carry on the operation of drilling continuously to a depth of 6,000 feet or a depth of 400 feet into the limestone (whichever should be the lesser depth) unless oil or gas should be found in the limestone in commercial quantities at a lesser depth.

By paragraph 5, the vendors agree to use and work the well in a skilful and proper manner.

Obviously, the effect of article 2 of the agreement between the Company and the licensors was to make the Company directly responsible to the licensors for the performance of these stipulations; that is to say, the Company agreed to observe, carry out and perform the obligation of the vendors, to commence the work of drilling a well within five weeks of the 1st of June, and to carry on such drilling operations continuously and diligently as just mentioned.

Pursuant to this obligation of the Company to the licensors and its obligation to the vendors, the Company entered into an agreement with one Head, the agreement referred to in article 6 of the agreement of the 1st of June, 1933, between the vendors and the Company and in the recitals of the Trust agreement of the 24th of June. Head's agreement is dated the 7th of June and he was to proceed to drill a well and the consideration he was to receive by article 21 of the agreement was $15,000 in cash and a further sum of $15,000 in respect of which the article provides as follows:

> The remaining balance, namely, Fifteen thousand ($15,000.00) Dollars is to be paid out of the sale of production at the rate of Two Thousand ($2,000.00) 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.

The situation then, after execution of the agreement of the 24th of June, which I shall refer to as the Trust agreement, was that the Company had entered into an agreement with the licensors to execute all the obligations of the vendors under the agreement between the vendors and the licensors by which the vendors had acquired the

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licence; that they had covenanted with the vendors to perform all the vendors' obligations under the last-mentioned agreement and, being, therefore, under contractual obligations with the licensors, as well as the vendors, to construct and to work the well, they had pursuant to these obligations entered into an agreement with Head by which Head had agreed to construct the well, and by which $15,000 of the $30,000 was to be paid by the Company out of production.

The Company had also agreed with the vendors to sell sufficient units of production as to secure the drilling of the well on the property. The Company was to hold the lease, drill the well and operate the same for such consideration as should be agreed upon between the Company and the Trustee for the unit holders; and, further, the units of production remaining after the drilling of the well had been provided for were to be the property of the vendors and one, Fred Elves.

The Company, by the Trust agreement, had agreed to pay the cost of constructing the well and all operating expenses, and to pay to the Trustee a royalty in cash amounting to the current market value of all petroleum and natural gas recovered from the well then being drilled, subject to deductions of overriding gross royalties amounting to 33% of all costs and necessary expenses for "taking care of the production including the cost of producing the well."

The Company in the Trust agreement declared its intention of selling this 67% of production in the form of units of production on a net basis for the purpose of financing and drilling the well. The agreement declared that the parties are entitled to these 67 units of production at the date of the agreement were those named, 43 of these units being the property of the Company, and 24 of them being held by others. The annual remuneration of the Trustee is provided for, as well as compensation to the Company for its services; and the Trustee agrees

that in the event of production being obtained in commercial quantities, it will, upon receipt of the royalty from the Company, distribute among the persons, firms and corporations entitled at the time of such distribution, as appears from its records, and in proportion to the interest or interests of each, all moneys so received, less only its charges as herein provided.

It is evident from what has been said that the parties intended, as the Trust agreement and the agreement with Head in the most explicit way provide, that all the costs of drilling and operating the well were to be paid by the Company out of gross production. These costs stood in precisely the same position as all other charges which were to be deducted from the gross value of the petroleum and natural gas produced for the purpose of ascertaining the royalty to be paid to the Trustee, such, for example, as the Head royalties.

As between the Company and the vendors, the sum of $15,000 now in question was, by force of the original vendors' agreement with the Company, to be charged on the vendors' units. The right of the Company and the holders of other than vendors' units to have this charge deducted in such a maner that its incidence should fall exclusively upon the vendors' units might have been worked out in various ways. It is not mentioned in the Trust agreement for the reason, possibly, that at that date 43 units out of the 67 allotted, were in the hands of the Company who were, therefore, in control of the situation. One obvious method of working out this right of the Company and of the holders of units other than the vendors' would be by a declaration by the Company and the holders of vendors' units that this sum was a charge on these units and a direction by them to the Trustee to pay it out of the share of the royalty which otherwise the Trustee would pay in its entirety to the holders of these units.

This, in effect, was what was accomplished by the agreement of February. The agreement is not conspicuously characterized by precision and the Crown naturally relies on the 4th recital. That recital says nothing whatever of relevancy to the question before us. It declares that it was agreed between the party of the first part, that is among the vendors and Elves, that certain costs and charges should be borne by the parties of the first part. It says nothing as to an agreement between the parties of the first part and the Company, or an agreement between them and the holders of the units.

As I have already said, there is not a suggestion in the vendors' agreement with the Company of the 1st of June that the vendors are to be under any personal liability

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in respect of the moneys due to Head by the Company. The agreement of February is simply a mode of giving effect to the agreement between the vendors and the Company that this particular sum and the other charges amounting in all to $20,000 should, as between the units of production sold to the public and the units of production transferred to the vendors and Elves, fall upon and be paid out of the latter. This was a right declared in the fundamental agreement by which the Company acquired from the vendors the licence, agreed to sell units of production for the purpose of drilling and financing a well, agreed to perform the obligations of the vendors, to operate the well, and to do so pursuant to the terms of an agreement to be entered into with the Trustee for the unit holders. From the very beginning, the arrangement that this payment, as part of the costs of production was to be charged exclusively upon the vendors' units and not spread over the units as a whole was a settled part of the plan and at no time had the vendors either a legal or a moral right to receive or to control the disposition of this sum.

The Company into whose hands came the proceeds of the sale of products of the well received this sum under a duty created by its agreement with Head to pay $15,000 to Head out of these proceeds. It received it under a duty created by the Trust agreement to pay out of the gross proceeds all costs and expenses including the "cost of producing the well." It did not receive these moneys as trustee or agent for or in any manner on behalf of the vendors. As to the Trustee, the royalty distributable by the Trustee amongst unit holders was a royalty ascertained by deducting the cost of the well as well as other expenses and, apart altogether from the agreement of February, it was the duty of the Company to see to it that the charge upon the vendors' units was made effective. The purpose of the arrangement made between the vendors and the Company acting for the protection of the unit holders generally would have been defeated if these moneys devoted from the beginning for the payment of this particular obligation had been allowed to come into the possession or under the control of the vendors. The purpose and effect of the agreement of February was to pro-

tect the rights of the Company and the unit holders as everybody recognized them.

From all this it results, in my opinion, that the sum in question was never, directly or indirectly, received by the appellant and his associates within the meaning of the statute.

The appeal will be allowed with costs throughout.

The judgment of Rinfret and Davis JJ. was delivered by

DAVIS J.—This is a Dominion Income Tax case arising out of the somewhat peculiar method (adopted, we are told, from an American practice) of dealing with speculative oil or gas production ventures which have in recent years become somewhat common in the western provinces. The method adopted is for the promoters to acquire, by lease or sublease or otherwise, the right to drill for and to take the oil or gas from certain defined lands upon the basis of giving to the land owner, and to the sublessor in case of a sublease, a certain proportion of the oil or gas, that may be produced or its money worth. The promoters then sell and transfer, as vendors, the rights so acquired to a joint stock company which they cause to be incorporated and organized, taking in part consideration for the transfer fully paid shares of the capital stock of the company. In this way the vendors become the shareholders of the company. But instead of the company acquiring whatever capital may be necessary for the drilling of wells and other incidental expenses to the point of production by the sale of further shares of its capital stock, the agreement with the new company provides, by way of further consideration for the transfer of the rights, that the company shall dispose of all its prospective profits (which, under the ordinary commercial practice of trading companies would ultimately be distributable among the shareholders pro rata) by the creation of fractions or interests (called "royalties" or "units of production") in the prospective profits of the company; sufficient of these to be sold to the public to raise the necessary money and the balance to become the property of the vendors to the company. It is plain then that when these "units of production" thus created are sold or disposed of to

such an extent that they absorb one hundred per cent. of the profits of the company, the holders thereof will become entitled to all the profits of the company which may arise from the production of oil or gas from the company's properties. The rights of the shareholders of the company will in consequence be confined to the capital of the company and they will not as shareholders be entitled to any distribution of the profits of the company which may result from the production of the wells. That being so, the vendors of the new company not only arrange that they shall become shareholders of the company but that they shall become entitled to some of the units of production in order to participate in profits if the venture proves successful.

In the case before us the vendors received 3,450 shares of the capital stock of the company, Sterling Royalties, Limited. These were divided and are held as follows:

Robert Wilkinson	1,300 shares
Clarence E. Snyder (the appellant)	800 shares
William S. Applegate	800 shares
Fred Elves	550 shares

So far as appears, those are the only shares of the capital stock of the company issued and outstanding.

But the agreement between the vendors and Sterling Royalties, Limited, provided not only for the issue of these shares of the capital stock of the company to the vendors as part consideration for the transfer of their rights, but Sterling Royalties, Limited, undertook to

> 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 (the vendors) 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 (a partner or associate of the three named parties of the first part) 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.

By virtue of that clause of the agreement the promoters or "vendors," besides becoming the holders of the shares of the capital stock of the company, became entitled to all

the units of production which would remain after the company had sold sufficient units of production to secure the drilling of a well on the property. What actually happened was this: the vendors had become under obligation to the head lessor and to the sublessor of the property for a total of 25% of whatever petroleum or natural gas might be produced. These obligations were assumed by Sterling Royalties, Limited. Another 8% of production was accepted by the Northwest Company Limited from Sterling Royalties Limited for the supply of the drilling equipment. These were percentages of gross production and aggregated 33%. Then Sterling Royalties Limited created 67 units of production to cover the balance of production; 36½ were sold for cash to the public by the company and the remaining 30½ units, subject to payment thereout of certain charges and expenses of the company amounting to $16,333.50, became the property of the vendors, under their agreement with the company, in the proportions of the shareholdings of each of them in the company as hereinbefore set out.

The drilling of the well for Sterling Royalties, Limited, was given by contract to one Head, who undertook to drill the well for $30,000, payable as follows: $15,000 in cash by monthly instalments of $2,000 each, the first of these instalments to be due and payable within thirty days after the actual commencement of drilling operations, the second instalment within thirty days thereafter and so on from month to month until the well was completed. (There is an acceleration clause with which we are not concerned.) The balance of the contract price, that is, a further sum of $15,000, was to be paid "out of the sale of production" at the rate of $2,000 per month but not in excess of 40% of the net production coming to the company after the payment of all royalties in connection with the said well.

Sufficient cash appears to have been raised by the sale to the public of 36½ units of production to meet the first $15,000 cash instalments that were to be paid to the contractor Head, but the second $15,000 that was only to be paid to Head "out of the sale of production" (i.e., if the well came into production) was part of the charges and expenses of the company amounting to $16,333.50

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which, by the agreement between the vendors and Sterling Royalties, Limited, were to be borne by and charged against the 30½ units of production to which the vendors were entitled as part of the consideration for the transfer of their rights to the company.

A trust agreement was made between Sterling Royalties, Limited, and The Trusts and Guarantee Company Limited for delivery to the trust company of the net proceeds of production of the well in question (i.e., after providing for the 33% of the gross production to the head lessor, the sublessor and the Northwest Company Limited which supplied the drilling equipment) and for the distribution of the same, after payment thereout of operating expenses, among the holders of the units of production. A form of trust certificate was adopted to evidence the title of the holders of the units of production.

The well came into production and the last-mentioned $15,000 paid to Head under his contract and the other costs and charges amounting to $1,333.50, all of which had been agreed upon between the vendors and the company to be charged against the "remaining" units of production (i.e., the vendors' 30½ units) were paid.

The Minister of National Revenue sought to charge the appellant Snyder, who was one of the vendors, with his portion of $16,333.50 and Snyder challenged this claim upon the ground that no part of the $16,333.50 was income or profits to the individual holders of the 30½ units. The Minister took the position that the vendors had acquired a 30½% interest in the production of the well and that they had in effect paid $16,333.50 to acquire that interest; that instead of paying that sum direct to the company as a capital expenditure on their part in order to acquire the 30½ units, they adopted this method of dealing with the sum in question whereby they charged their 30½ units of production with the payment of the $16,333.50, taking their profits to the extent of $16,333.50 to acquire as many as 30½ units for themselves.

But no part of this total sum of $16,333.50 ever reached the vendors; in fact they were not entitled to any of it. The agreement was that they were to get whatever units of production were not sold to the public but that these "remaining" units were to be charged with the payment of this $16,333.50. The share or interest of the vendors

in the profits of the company from the production of the well was in fact 30½% less $16,333.50. If the speculation had not proved the success it apparently did, and 30½% of the sales of the production of its well had never amounted to more than $16,333.50, these vendors would never have become entitled to any profits at all. This statement is not exactly accurate, in that the 33 units set aside for the head lessor and the sublessor and the equipment company were gross production units, but that is not for our present purpose of any real consequence.

Suppose Snyder and his associates had never transferred their rights to Sterling Royalties Limited but had proceeded with the venture themselves as a partnership undertaking and had made the same arrangement with the drilling equipment company to take 8% of the production instead of cash and had made the same arrangement with Head to drill the well as Sterling Royalties Limited made—what would have been the result? Snyder and his associates in that event would have been entitled to 67% of the production; that is, the total production less 25% to which the head lessor and the sublessor were entitled and less 8% to which the equipment company was entitled. But Snyder and his associates would have had to pay the $30,000 to Head. The result of their transaction with Sterling Royalties Limited, however, was that they turned over, for better or for worse, their rights to that company, in consideration of certain shares and units of production, and that company by the sale to the public of certain units of production raised sufficient money to pay Head the first $15,000 on his contract and whatever other or incidental outlay was involved in the company bringing its well to the point of production. Snyder and his associates, in consequence of their arrangement wisely or unwisely made by them with Sterling Royalties Limited, have now only 30½% of the profits of the venture less the sum of $16,333.50 agreed between them and the company to be paid out of and charged against the first proceeds of this 30½%.

We are dealing with income tax and it is perfectly plain that the appellant Snyder never received any part of the $16,333.50 nor was he ever entitled to receive any part of it.

Lord Macmillan in the Privy Council in the *Tata Hydro-Electric* case (Bombay) (1), said at p. 694:

> Before their Lordships counsel for the Crown did not seek to support the judgment of the High Court in the present case on the ground that it was ruled by the decision in the *Pondicherry* case (1931) L.R. 58 I.A. 239, and in their Lordships' view he was well advised in recognizing the clear distinction between that case and the present case. In the *Pondicherry* case the assessees were under obligation to make over a share of their profits to the French Government. Profits had first to be earned and ascertained before any sharing took place. Here the obligation of the appellants to pay a quarter of the commission which they receive from the Tata Power Co., Ld., to F. E. Dinshaw, Ld. and Richard Tilden Smith's administrator is quite independent of whether the appellant made any profit or not. Indeed, if on their year's operations as a whole they were to make a loss and incur no liability to income-tax they would nevertheless have to pay away a quarter of the commission in question to the parties named. The commission in truth is not profit or gain; it is only an item or factor in the computation of the appellants' profits or gains. Their Lordships regard this as a fundamental distinction.

I would refer to the language of Sir Wilfrid Greene, the Master of the Rolls, in the recent case of *British Sugar Manufacturers, Limited,* v. *Harris* (*Inspector of Taxes* (2):

> Various authorities have been referred to. Speaking for myself, I find the greatest assistance from two passages, one of them is a passage in the judgment of Romer L.J. in this Court in the case of *Union Cold Storage Co.* v. *Adamson* (3). What Romer L.J. says there (at p. 328) is that in order to succeed in that case the Crown would have had to establish the following proposition: "That where a company, for the "purpose of enabling it to carry on its trade and earn profits in the "trade, places itself under an obligation to make money payments, the "amount of which is dependent upon the profits earned, or the payment "of which is contingent upon certain profits being earned, payments made "in discharge of that obligation are payments made out of the profits or "gains of the company, within the meaning of Rule 3 (*l*). In my opinion, "for that proposition there is no foundation at all in principle or on "authority." The case that was being dealt with there was a case where the obligation to make the payment was dependent upon the profits earned, but it seems to me that the reasoning and the expressions of Romer L.J. equally apply to the case where the payment to be made is a commission or a percentage of profits earned.
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> The other passage is a passage in the judgment of the Privy Council delivered by Lord Maugham in the case of *Indian Radio and Cable Communications Co.* v. *Income-tax Commissioner, Bombay Presidency and Aden* (4). That was a case into the facts of which I need not go, but it is important as containing a reference to the particular phrase in an earlier case which affected the mind of Finlay J. in the present case. That case having been brought to the attention of the Board in the

(1) [1937] A.C. 685.
(2) [1938] 2 K.B. 220, at 235, 236, 237.
(3) (1930) 16 Tax Cas., 293.
(4) [1937] 3 All E.R. 709.

Indian Radio case, Lord Maugham said this (at p. 713): "It may be "admitted that, as Mr. Latter contended, it is not universally true to "say that a payment, the making of which is conditional on profits being "earned, cannot properly be described as an expenditure incurred for the "purpose of earning such profits. The typical exception is that of a "payment to a director or a manager of a commission on the profits of "a company. It may, however, be worth pointing out that an apparent "difficulty here is really caused by using the word 'profits' in more "than one sense. If a company, having made an apparent net profit "of £10,000, has then to pay £1,000 to directors or managers as the con- "tractual recompense for their services during the year, it is plain that "the real net profit is only £9,000. A contract to pay a commission at ten "per cent on the net profits of the year must necessarily be held to mean "on the net profits before the deduction of the commission, that is, in the "case supposed, a commission on the £10,000." That passage, in my opinion, contains sufficient to dispose of this case, and if I may link it up, as I understand it, with what I said a moment ago about the two accounts, the two accounts are I think what may be called the accountancy aspect of the two different senses in which the word "profits" is used in these cases, as explained by Lord Maugham. Once you realize that as a matter of construction the word "profits" may be used in one sense for one purpose and in another sense for another purpose, I think you have the real solution of the difficulties that have arisen in this case.

The learned President of the Exchequer Court held that Snyder was liable to pay income tax in respect of his portion of the $16,333.50 charged against the 30½ units, but with great respect I do not think for the reasons above given it can properly be treated as taxable income. I would therefore allow the appeal and set aside the judgment appealed from, and the assessment and decision of the Minister in so far as the item of $16,333.50 is concerned. The appellant is entitled to his costs throughout. As a result of this conclusion it becomes unnecessary to consider the cross-appeal of the Minister on the question of costs. The cross-appeal should be dismissed, but without costs.

CROCKET J. (dissenting)—I agree with my brother Hudson and the President of the Exchequer Court that the appellant and his associates were not entitled to deduct from the income of their royalty trust certificates for the year 1934 the $16,333.50, which Sterling Royalties Limited (of which they were the sole directors and shareholders) applied at their request to the payment of the indebtedness then outstanding for the drilling of the oil well. That amount admittedly represented 30½% of the net proceeds of the oil produced from the well and sold,

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(see Snyder's evidence, p. 40), to which they had become entitled by the transfer to them by Sterling Royalties Limited, after the completion of the drilling operations and the oil well had been brought into production, of the 30½ remaining so-called units of production that had been previously held by Sterling Royalties for sale to the public for that purpose, upon the appellant and his associates undertaking to liquidate the outstanding indebtedness of Sterling Royalties for completion of the drilling operations. The arrangement, under which the four partners acquired these 30½ units, is formally set out in the pooling agreement entered into between them and Sterling Royalties Limited under date of February 6th, 1934. Its practical effect was to charge the income payable on the royalties certificates they acquired with a capital outlay of $16,333.50, and to make this amount the purchase price of the 30½ units of production. The fact that instead of having Sterling Royalties Limited hand over the net income of their royalties certificates to their trustees for distribution among them, as they were bound to do under the trust agreement, they chose to direct the operating company to apply the whole amount to the liquidation of the capital indebtedness they had assumed, does not in my opinion entitle them to deduct the amount from their income of that year as a current disbursement.

I agree with my brother Hudson that the appeal should be dismissed with costs.

HUDSON J. (dissenting)—The facts have been set forth at length by the learned President in the court below and I shall refer only to those which I think sufficient to dispose of the matter.

Snyder and his associates were the licensees of oil and gas rights and, under agreement granting them the licence, they covenanted to drill a well and their obligation to do this remained throughout until the well had been drilled and completed.

The next step was the agreement made with Sterling Royalties Limited and it must be borne in mind that Snyder and his associates were the sole shareholders and directors of this company. The plan adopted for financing the operation was to sell what were called units of production or percentages, and under clause 5 of this agree-

ment it was contemplated that sufficient units should be sold to pay for the cost of drilling the well and that Snyder and his associates should get the remaining units up to the total number to be issued, but the agreement also contemplated the possibility of sufficient units not being sold to provide for the total cost of drilling, and to cover this, provision was made and incorporated in clause 6 as follows:

> 6. 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 ($15,000.00) Dollars, part of the price of drilling the well which it is proposed to pay to Hillary H. Head, drilling contractor, from production in an agreement now being negotiated with him.

It should be observed here that the effect of this agreement was to provide for the disposal of the company's entire net income from the production of the well under consideration not to the shareholders as such but to the holders of units of production or royalties, whichever term is appropriate.

When the well was drilled and came into production the pooling agreement dated 6th February was made. Prior to that date the unsold units under the agreement with Sterling Royalties Limited had already been divided between Snyder and his associates. There was, of course, attached to these units the obligation provided for in clause 6 of the agreement with Sterling Royalties. It may be that the recitals in the pooling agreement do not correspond exactly with the obligations under clause 6 above mentioned, but the pooling agreement provides specifically that Snyder and his associates agree to pool their royalties or percentages of production for the purpose of paying all costs, charges and expenses including the payment to Head which is the matter of controversy in this litigation. It is there further provided that the proceeds derived from the said royalties be paid to Sterling Royalties for the purpose of paying the costs and charges including the amount payable to Head, and there is a further provision authorizing the trustees of the money to pay these moneys over for that purpose. This pooling agreement clearly recognizes the realities of the situation.

The appellant was examined on this point and gave his evidence as follows:

Q. That agreement was signed by the four of you?—A. Yes.
Q. You were the four shareholders of the company?—A. Yes.
Q. Are you a Director?—A. Yes.
Q. Was Mr. Wilkinson a Director?—A. Yes.
Q. And Mr. Elves?—A. Yes.
Q. And Mr. Applegate said he was?—A. Yes.
Q. Now, I call your attention to clause 1 of that Agreement Exhibit No. 6. That clause reads:

"(1) The Parties of the First Part hereby agree to pool their royalties or percentages of production for the purpose of paying all costs, charges and expenses agreed to be paid by them and amounting to approximately Twenty thousand ($20,000.00) Dollars, the details and items of which said amount are well known to each of the Parties of the First Part, and include the bonus of Fifteen thousand ($15,000.00) Dollars"

(which really became $16,333.50)

"payable to Hilary H. Head under a drilling agreement with him dated 7th June, 1933."

Now how do you explain those words "agreed to be paid by them"?—A. That clause means exactly what it says. We agreed to pay it out of royalties that we owned.

Q. This agreement goes on further to say in clause 2 that the parties of the First Part further agree to pool the proceeds of the said royalties or percentages; now when you speak of the proceeds of said royalties or percentages, what do you mean?—A. What was received for the oil that was sold.

Q. Under your Royalty Trust Agreement you had the right to take oil from the well or take money, have the oil sold by the Trustee or take money?—A. Yes.

Q. So that it is really the income from the well; is that right?—A. It is the income from the royalties that were unsold that came to us; what I mean is this, that it was the money paid to us from the oil sold that was credited to royalties that belonged to that pool.

Q. And your share of that was what per cent?—A. 30½% of the net production.

Q. And by that you mean after the Head royalty was taken off?—A. Yes.

Q. After the costs of operation?—A. Yes.

Q. And out of whatever was left you got 30½%?—A. That is right.

Q. And that proportion of the net amount in each year the well produced came to the four of you?—A. Yes.

Q. And you pooled that amount and gave instructions to the Trustee to pay that sum to Sterling Royalties?—A. That is right.

The auditors' statement of Sterling Royalties attached to the appellant's income tax return shows the money in question as "applied against liability of" Snyder. This confirms the view that Sterling Royalties were simply taking care of a recognized obligation of Snyder out of the proceeds of production, and under section 1, chapter 55, of the Statutes of Canada, 1934, all royalties or other

periodical receipts dependent upon the production or use of real property, notwithstanding that the same were payable on account of the use of such property, are taxable.

It seems to me that Sterling Royalties in receiving the proceeds of production allocated to the units of Snyder and the others were receiving it as agents for them, and in paying Head they were likewise paying it as agents for them. If this be so, then it is simply a case of paying a capital expenditure out of the earnings of the business.

I think that in all respects material to this litigation Sterling Royalties should be regarded simply as agents for Snyder and his associates from the making of the first agreement entered into with that company. For these reasons, I think the appeal should be dismissed with costs.

There was a cross-appeal by the respondent in respect of costs in the court below. I think, however, that this was a matter within the discretion of the learned trial judge and would not disturb his judgment in this respect.

Appeal allowed with costs.

Solicitors for the appellant: *Patterson, Hoff & Patterson.*

Solicitor for the respondent: *W. S. Fisher.*