IN THE MATTER OF THE INCOME WAR TAX ACT

AND

IN THE MATTER OF THE APPEAL OF MRS. CATHERINE SPOONER OF THE CITY OF CALGARY, IN THE PROVINCE OF ALBERTA

MRS. CATHERINE SPOONER.....APPELLANT;

AND

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

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*Feb. 5, 6.
*April 28.

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Income tax—Income War Tax Act, 1917 (Dom.), as amended—"Income" —Royalty reserved to vendor of land, of percentage of oil, etc., produced by purchaser.

Appellant sold to a company land, including minerals, for a cash sum, shares in the company, and a royalty (so called) reserved of 10% of all oil, etc., produced and saved from the land free of cost to appellant on the premises. The company covenanted to commence and continue drilling operations, and, on discovery of oil, to instal machinery

*PRESENT:—Duff, Newcombe, Rinfret, Lamont and Cannon JJ.

(1) (1910) 42 Can. S.C.R. 694.

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for pumping it, etc. It struck oil, sold all the oil produced in 1927, and paid to appellant, as being the royalty under the agreement, one-tenth of the gross proceeds thereof. The question now in issue was whether or not appellant, in respect of the amount so received by her as royalty, was assessable by the Crown for income tax under the *Income War Tax Act, 1917* (Dom.) as amended. Appellant was not a dealer in or in the business of buying and selling oil lands or leases.

Held: Appellant was not so assessable. The amount in question was not income to her within the meaning of the Act. *Jones* v. *Commissioners of Inland Revenue,* [1920] 1 K.B. 711, distinguished, having regard to the subject matter and statutes involved. Judgment of the Exchequer Court (Audette J.), [1930] Ex. C.R. 229, reversed.

APPEAL from the judgment of Audette J. in the Exchequer Court of Canada (1), holding the appellant liable for income tax with respect to certain monies received by her as royalty under an agreement.

By agreement dated April 15, 1925, the appellant sold certain land to a company, which, in consideration of the sale, agreed to pay to the appellant a certain cash sum upon the execution of the agreement by the company, and to issue to her a certain number of shares of the company's capital stock, and further agreed

in consideration of the said sale to deliver to the order of the said vendor (appellant) the royalty hereby reserved to the vendor, namely: ten per cent of all the petroleum, natural gas, and oil, produced and saved from the said lands free of costs to the said vendor on the said premises. * * *

The material clauses of the agreement are sufficiently set out or described in the judgment now reported. (Also the agreement is set out in full in the judgment of the Exchequer Court (2)).

During the fall of 1926 the company struck oil in commercial quantities on the land.

The whole of the oil produced in 1927 (the year in question) was sold by the company and out of the monies received from the sale of the oil (before the company deducted expenses or made any reduction therefrom) one-tenth of the gross proceeds were paid over to the appellant.

In respect of the money so paid over to the appellant, she was assessed for income tax under the *Income War Tax Act, 1917* (Dom.) as amended. She appealed from the assessment on the ground that the money so received by her was not taxable income. The Minister of National

(1) [1930] Ex. C.R. 229.

(2) [1930] Ex. C.R. 229, at 231-233).

Revenue affirmed the assessment on the ground that under and by virtue of the agreement between the appellant and the company the appellant

secured unto herself an income, fluctuating annually in accordance with the production of oil and that the monies realized from the sale of such oil either by herself or through her agent or by contract or otherwise, such monies coming to her constitute taxable income and she is taxable in respect thereof, subject however, to adjustment as to depletion * * *

The appellant appealed from the decision of the Minister, which appeal was dismissed by Audette J. in the Exchequer Court of Canada (1). Leave to appeal to the Supreme Court of Canada was granted by a judge of this Court.

At the opening of the trial in the Exchequer Court, the following facts were agreed upon by counsel for the parties:

1. The Appellant in 1902 purchased from the Canadian Pacific Railway the lands referred to in the hereinafter referred to Agreement along with other lands, the whole for the purpose of conducting ranching operations thereon. The Appellant was not and is not a dealer in or in the business of buying and selling oil lands or leases.

2. The Appellant was in 1927 and is now a resident in Canada.

3. The Respondent determined the income of the Appellant to be in the sum of $9,570.41, being monies received as "Royalties" under the Agreement hereinafter referred to.

4. Vulcan Oils Limited was and is a Company incorporated on the 13th day of April, 1925, under the laws of the Province of Alberta, organized and operated for the purpose of drilling for and procuring the production and vending of oil.

5. That Vulcan Oils Limited and the Appellant entered into an Agreement dated the 15th day of April, 1925, a true copy of which has been filed with and forms part of the records of this Court.

6. That of the property referred to in the said Agreement the Appellant was the owner in fee simple except as to the coal therein and thereunder.

7. That in accordance with the said Agreement Vulcan Oils Limited entered upon the property as in the Agreement described and commenced the operations of drilling for oil with equipment and in a manner satisfactory to the Appellant.

8. That during the fall of 1926 Vulcan Oils Limited struck oil (as referred to in the contract) "in Commercial quantities on the said lands."

9. A transfer of the petroleum, natural gas or oil has not been effected and the Appellant is still the owner in fee simple of the said lands except as to coal.

10. That due to the mining operations the whole of the oil produced in the year 1927, the year in question, was sold by Vulcan Oils Limited and out of the monies received from the sale of the oil (before the Company deducted expenses or made any reduction therefrom) one-tenth of the gross proceeds were paid over to the Appellant.

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11. That the oil produced by Vulcan Oils Limited is not in fact physically divided by the Company nor is it sold in two distinct portions of 90 per cent and 10 per cent, but the whole is handled in bulk. Vulcan Oils Limited never in fact delivered any of the actual oil to the Appellant, but has in fact delivered (as per the Agreement), "to the order of the said Vendor the royalties hereby reserved to the Vendor" (the Appellant), the delivery in fact being effected by payment in cash.

12. That the Appellant, or her Agent, has in fact from time to time entered upon and viewed the operations and workings of Vulcan Oils Limited as to the operations of the mining of oil on the property.

13. The Appellant upon entering into the said Agreement received the sum of $5,000 in cash and 25,000 shares of Vulcan Oils Limited at a par value of one dollar each, as fully paid up and since the production of oil and the sale thereof has been receiving "royalties" under the contract.

By the judgment now reported the appeal to the Supreme Court of Canada was allowed with costs throughout.

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

C. Fraser Elliott K.C. and *W. S. Fisher* for the respondent.

The judgment of the court was delivered by

NEWCOMBE J.—This is a tax appeal, depending upon the meaning and application of the *Income War Tax Act*, c. 28 of 1917, as amended.

The case came before Audette J., of the Exchequer Court of Canada (1), upon appeal from the decision of the Minister of National Revenue, and was heard upon admissions.

By agreement under seal of 15th April, 1925, the appellant, therein called the vendor, of the first part, who was then the owner in fee simple of the lands to which the agreement relates, agreed with Vulcan Oils, Limited, therein called the company, of the second part, upon the recital that the appellant had agreed to sell to the company the land described as follows, that

The Vendor hereby sells, assigns, transfers and sets over unto the Company, its successors and assigns, all her right, title and interest, in and to the following property; namely, the South twenty acres of the North West quarter of Section Thirteen (13) Township Twenty (20) Range Three (3) West of the Fifth Meridian, which includes all mines and minerals, on, in or under the said lands. Subject to the provisos, conditions and royalties hereinafter reserved.

(1) [1930] Ex. C.R. 229.

The company, in consideration of the sale, agreed to pay to the vendor the sum of $5,000 in cash, upon the execution of the agreement by the company, and to issue to the vendor, or her nominee, 25,000 shares of the company's capital stock of the par value of $1 each, fully paid up.

And, by clause 3, it is stipulated that

> The Company hereby further agrees in consideration of the said sale to deliver to the order of the said Vendor the royalty hereby reserved to the Vendor, namely: ten per cent. of all the petroleum, natural gas, and oil, produced and saved from the said lands free of costs to the said vendor on the said premises. And the said petroleum, natural gas and oil shall be delivered under the instructions and upon the method decided by the Vendor, and the Company further covenants and agrees that it will deliver to the said Vendor the beforementioned percentage of petroleum, natural gas and oil saved on the said land at least once in every thirty days and will not sell or remove any petroleum, natural gas or oil from the said premises until the said percentage or share thereof belonging to the Vendor shall have been delivered as aforesaid.

By clause 5, the company covenanted to proceed forthwith to obtain standard drilling machinery, fully equipped; to commence drilling operations upon the lands as expeditiously as possible, "and to continue such drilling operations without interruption, except as may be unavoidable, until oil and/or gas in commercial quantities is struck or to a minimum depth of 4,500 feet."

By clause 6, the company covenanted, upon oil or petroleum being discovered, to instal and maintain the necessary machinery for pumping or procuring and delivering the oil or petroleum in pipes, reservoirs or tanks, and to carry on the operations.

Clause 7 reads as follows:

> In the event of oil or gas being discovered in commercial quantities on the said lands the Vendor as part of the consideration for this Agreement, covenants to transfer to the said Company by good and sufficient transfer in fee simple the said twenty acres of land freed and discharged from all encumbrances and also shall transfer to the said Company by good and sufficient transfer in fee simple freed and discharged from all encumbrances the South twenty acres of the North West Quarter of Section twenty-four (24) Township twenty (20) Range three (3) West of the 5th Meridian and such transfers shall be completed and delivered forthwith after oil or gas is discovered in commercial quantities by the said Company, reserving always however to the Vendor the said royalty of ten per cent of all petroleum, natural gas and oil in respect to the said South twenty acres of the N.W. ¼ of Section 13, Township 20, Range 3, West of the 5th Meridian and also free access on and over all said lands described in this paragraph to an extent not exceeding three trails and the location of the said trails shall be selected by the Vendor.

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It will be observed that clause 3, quoted above, by which, as well as by clause 7, the royalty is said to be reserved, introduces a covenant, on the part of the company, by way of further consideration for the sale; and that the company thereby agrees to deliver to the vendor, on the premises, ten per cent. of the petroleum, natural gas and oil produced and saved from the lands sold, free of cost to the vendor; the delivery to be made at least once in every thirty days; and this suggests a question as to whether the consideration or so-called royalty, which consists of ten per cent. of the minerals recovered, is validly reserved; for, it is said in Sheppard's Touchstone (80), para. 10:

> If a man grant land, yielding or paying money or some such like thing [as a rose, a pound of cummin, etc.] yearly, [or at any other period] this is a good reservation. But if the grantee covenant to pay such a sum of money, or to do such a thing yearly, this is no good reservation, but a covenant to pay a sum of money in gross, and not as a rent, [but whether a clause shall amount to a reservation, or to a covenant, is frequently a question of construction].

One is concerned to know whether the appellant has acquired that which is taxable as income; and, for the purposes of the Act, "income," as defined by the relevant provisions of section 3 (1), means

> The annual net profit or gain or gratuity, whether ascertained and capable of computation as being wages, salary, or other fixed amount, or unascertained as being fees or emoluments, or as being profits from a trade or commercial or financial or other business or calling, directly or indirectly received by a person from any office or employment, or from any profession or calling, or from any trade, manufacture or business, as the case may be; and shall include the interest, dividends or profits directly or indirectly received from money at interest upon any security or without security, or from stocks, or from any other investment, and, whether such gains or profits are divided or distributed or not, and also the annual profit or gain from any other source, with the following exemptions and deductions:—
>
> (*a*) such reasonable allowance as may be allowed by the Minister for depreciation, or for any expenditure of a capital nature for renewals, or for the development of a business, and the Minister, when determining the income derived from mining and from oil and gas wells, shall make an allowance for the exhaustion of the mines and wells;
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> * * *

Now it is clear that one-tenth of the petroleum, gas and natural oil produced from the lands sold is not profit in the hands of the company, which is at the expense of producing it and is bound to give it to the appellant, and, so far as we know, the company did not otherwise make any profit or gain. Also, as the appellant has no reversion, and

receives one-tenth of the specified minerals as part of the consideration of the sale of the inheritance, it is most unlikely that Parliament intended to include the appellant's tenth as income, within the meaning of paragraph (*a*) of section 3, above quoted. Why should a vendor have an allowance for the exhaustion of that which he has sold and been paid for? The definition clause must be interpreted in the light of section 36 of the general *Interpretation Act*, R.S.C., 1927, c. 1, which was in force long before the enactment of the *Income War Tax Act, 1917*, and it provides that

> Definitions or rules of interpretation contained in any Act shall, unless the contrary intention appears, apply to the construction of the sections of the Act which contain those definitions or rules of interpretation, as well as to the other provisions of the Act.

And thus, it follows that the word "income" in the first line of section 3 (1) of the *Income War Tax Act, 1917*, and the same word in clause (*a*) of that subsection are controlled by the same statutory definition. The stipulated tenth is not rendered annually, but at least every thirty days after production, and that irrespective of whether the operation results in profit or loss. It is by the agreement, for the lack of an apt definition, termed a "royalty"; but, whether or not it may appropriately be named a royalty or an annuity, the statute does not, in terms, charge either royalties or annuities, as such; and here the appellant has converted the land, which is capital, into money, shares and ten per cent. of the stipulated minerals which the company may win. What the appellant will realize, under the covenant, is, of course, uncertain; although it may be ascertained in the event.

On the other hand, it may be assumed that if the project prove unprofitable, the minerals will not be raised and that circumstance, as well as the uncertainty of the extent of minerals available, contributes to the speculative character of the appellant's interest; but, nevertheless, the appellant's receipts come from a potential source of capital. The taxable commodity is "income," which means, by the definition, annual profit or gain; and for the appellant, there is no question of profit or gain, unless it be as to whether she has made an advantageous sale of her property.

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In *Jones* v. *Commissioners of Inland Revenue* (1), a case upon which the Crown relies, the appellant sold his interest in certain patents for a sum in money and percentage, called a royalty, payable for ten years, upon the sale of all machines constructed under the patent; and it was held that the sums received by the appellant in respect of the royalty were income and properly so computed for the purpose of the supertax. Rowlatt J., who pronounced the judgment, said at pp. 714-715, as to the contention that the ten per cent. upon sales was part of the consideration for the transfer:

> There is no law of nature or any invariable principle that because it can be said that a certain payment is consideration for the transfer of property it must be looked upon as price in the character of principal. In each case regard must be had to what the sum is. A man may sell his property for a sum which is to be paid in instalments, and when that is the case the payments to him are not income. *Foley* v. *Fletcher* (2). Or a man may sell his property for an annuity. In that case the Income Tax Act applies. Again, a man may sell his property for what looks like an annuity, but which can be seen to be not a transmutation of a principal sum into an annuity but is in fact a principal sum payment of which is being spread over a period and is being paid with interest calculated in a way familiar to actuaries—in such a case income tax is not payable on what is really capital: *Secretary of State for India* v. *Scoble* (3). On the other hand, a man may sell his property nakedly for a share of the profits of the business. In that case the share of the profits of the business would be the price, but it would bear the character of income in the vendor's hands. *Chadwick* v. *Pearl Life Assurance Co.* (4) was a case of that kind. In such a case the man bargains to have, not a capital sum but an income secured to him, namely, an income corresponding to the rent which he had before. I think therefore that what I have to do is to see what the sum payable in this case really is. The ascertainment of an antecedent debt is not the only thing that governs, although in many cases it is a very valuable guide. In this case there is no difficulty in seeing what was intended. The property was sold for a certain sum, and in addition the vendor took an annual sum which was dependent upon the volume of business done; that is to say, he took something which rose or fell with the chances of the business. When a man does that he takes an income; it is in the nature of income, and on that ground I decide this case.

These observations of the learned judge have their application to the statutes which were under consideration in that case; but the question here is, does a man take an income within the meaning of the Canadian Act when he sells his land in consideration of a part of the oil and gas to be extracted from it by the purchaser, if, as is stated in

(1) [1920] 1 K.B. 711.
(2) (1858) 3 H. & N. 769.
(3) [1903] A.C. 299.
(4) [1905] 2 K.B. 507, 514.

the present admissions, " the appellant was not and is not a dealer in or in the business of buying and selling oil lands or leases "; and, when there is no provision for taxing the property delivered by the purchaser to the appellant, either as annuity or royalty; neither of these words having been used in the statute to describe any right such as that which the vendor acquired under the agreement.

It is the duty of the court to ascertain the real nature of the transaction. It was argued for the respondent that the appellant sold her land and joined with the purchaser in the business of recovering the minerals, but she clearly was not engaged in the business; that suggestion is excluded by the facts and admissions.

The case is not without its difficulties, but I am not satisfied that the Crown has made out its claim. And, " inasmuch as it is the duty of those who assert and not of those who deny, to establish the proposition sought to be established, I think the Crown must fail." *Secretary of State in Council of India* v. *Scoble* (1).

Appeal allowed with costs.

Solicitor for the appellant: *H. S. Patterson.*
Solicitor for the respondent: *C. Fraser Elliott.*