1960
Oct. 14
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BETWEEN:

HERBERT WILLIAM PURCELL .....APPELLANT;

AND

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

Revenue—Income Tax Act, R.S.C. 1952, c. 148, ss. 3, 4, and 139(1)(e)—Capital profits or income—Profits obtained from trading in syndicate interests and vendor stock constitute income—Appeal dismissed.

Appellant from 1946 to 1949 was a shareholder and employee of a brokerage company which underwrote and marketed shares of oil producing companies. In 1949 he disposed of his holdings in the brokerage company and joined with two others in a partnership or syndicate operating in the natural gas and oil field, and acquired a working interest in an oil property that came into production. In 1950 and 1952 he sold parts of his working interest and the profits resulting therefrom were assessed as income. In 1950 he and another member of the syndicate transferred to a company which he organized certain oil properties for one million shares of stock which were disposed of at a profit in 1952. The profit on the sale of these shares was also assessed as income. An appeal from such assessment to the Tax Appeal Board was dismissed and appellant now appeals to this Court.

Held: That the appellant was engaged in the business of dealing in oil interests and oil leases in any way through which a profit might be obtained and in promoting companies having the same objectives, and the syndicate of which he was a member entered into agreements with lease owning and drilling companies in the hope of obtaining profit from the percentages of revenue production to which they were entitled under the terms of such agreements.

2. That in the course of his activities as a promoter the appellant had organized the company of which he became managing director at no salary to which certain leases were transferred for a return of shares which were placed in escrow from the sale of which he hoped to realise a profit when the escrow terminated, and such escrow shares were part of his stock in trade and not an investment.

3. That the appellant was rightly assessed for income tax on the profits resulting to him from all these transactions and the appeal is dismissed.

APPEAL from the Tax Appeal Board.

The appeal was heard before the Honourable Mr. Justice Ritchie, Deputy Judge of the Court, at Vancouver.

D. T. B. Braidwood for appellant.

T. Z. Boles for respondent.

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

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RITCHIE D.J. now (April 7, 1961) delivered the following judgment:

This appeal from a July 13, 1959 decision of the Tax Appeal Board concerns a re-assessment of income tax made on December 21, 1956 in respect of amounts added by the Minister to the income of the appellant for the taxation years 1950 and 1952.

The appellant, now residing in Calgary, was resident in Vancouver during both of the taxation years involved herein. From 1946 to 1949 he was a shareholder and employee of H. J. Bird and Company, Limited, a Vancouver investment and stock brokerage company which, as part of its regular business, underwrote and marketed shares of oil producing companies. In the latter part of 1949 he disposed of his holdings in the Bird company and, early in 1950, joined with two others in a partnership or syndicate operating in the natural gas and oil field.

As I understand the evidence, the syndicate agreement was not reduced to writing until, on March 22, 1950, an assignment from Leduc Calmar Oil Company Limited of a farmout agreement with Imperial Oil Limited had been obtained. The syndicate agreement then entered into between the appellant and his two associates is headed " P. C. M. Syndicate No. 2," is dated June 2, 1950 and provides all expenses and profits of the syndicate shall be borne and divided share and share alike and that the syndicate shall be governed by a majority vote of the members.

Under the terms of the farmout assignment from Leduc Calmar, the syndicate assumed an obligation to drill a petroleum exploratory well to a depth sufficient to test all zones down to and including the D-2 zone of the Devonian. To fulfill this obligation an agreement was negotiated with an organization known as McRae Developments. The terms of this agreement included, *inter alia,* provisions that:

(*a*) McRae, at its own expense, should drill a well to the producing zone in the D-2;

(*b*) if production in commercial quantities should be obtained, the cost of completion would be borne in the ratio of 57 by McRae and 20 by the syndicate;

(*c*) five per cent of the revenue from production of the first well, after payment of proper charges and operating expenses, would be paid to the syndicate;

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(*d*) seventy-seven per cent of the revenue from production of the first well would be paid to the Royal Bank of Canada, until funds sufficient to defray the cost of drilling and completing a second well were accumulated;

(*e*) after accumulation of funds sufficient to defray the cost of drilling and completing a second well, 41% of the revenue from the first well would be paid to the syndicate until they had received 20% of the total production revenue from that well;

(*f*) when the 41% of revenue payments to the syndicate totalled an amount equivalent to 20% of the total production revenue, the syndicate thereafter would be paid 20% of the production revenue from the first well; and

(*g*) revenue from production of the second well would be paid to the Royal Bank of Canada until funds sufficient to defray the costs of drilling and completing a third well were accumulated and thereafter a like procedure as to distribution of revenue from the first well would be followed.

The syndicate, at a cost of approximately $75,000, fulfilled all its obligations under the McRae agreement.

One branch of the appeal rests largely on a distinction the appellant draws between the 5% of revenue payable to the syndicate under the above clause (c) and the 20% of revenue they were to receive under clauses (f) and (g) above. He refers to the former as a "net royalty" and to the latter as a "working interest." For convenience I shall use the designations employed by the appellant. He was allotted a 4½% share of the working interest.

The appellant defines a net royalty as a royalty payable to parties who do not contribute to the cost of drilling, exploration or development of a well but, in the event of it proving successful, do contribute to operational and marketing costs but have no equity, or interest, in the equipment.

A "working interest" is described by the appellant as an interest arising from an agreement between an owner of an oil property and a developer under the terms of which the developer undertakes to drill an exploratory well and both the owner and developer assume obligations and liabilities in respect of:

(*a*) the drilling of the well;

(*b*) the completion of the drilling;

(*c*) in the development; or

(*d*) in all three of the phases involved in bringing a well into commercial production.

If the well proves successful, those who hold a working interest participate in the revenue remaining after payment of the operational and marketing expense to which they contribute in proportion to the interests they hold. The appellant also says that holders of a working interest own an equity, or interest, in the equipment necessary to secure production.

The McRae drilling operations were successful. At least two wells came into production. No "net royalties," however, accrued to the syndicate. They had disposed of the right to receive the initial 5% of the distribution of production revenue to which they were entitled. The proceeds of the disposition of the net royalty were, after payment of expenses, distributed among the three partners in the syndicate.

The Minister, under the designation "Net P. C. M. Royalty," added $8,931.46 to the appellant's 1950 income as his share of the proceeds of the sale of the net royalty. Tax was paid without objection on such addition to income.

The appellant declared as income and paid tax on the monies paid to the Royal Bank of Canada or to the Prudential Trust Company and credited to him in respect of his 4½% share of the working interest.

In July of 1950 the appellant sold to a Mr. Fox, for a consideration of $3,487.75, one-half of one per cent of his working interest. In 1952 he sold a further one per cent to a Mr. Reid for the price of $6,500. The Minister has assessed the proceeds of the two sales and the appellant has appealed from such assessment. He continues to pay tax on the monies received in respect of his remaining 3% of the working interest.

In December 1950 the appellant and another member of the P. C. M. syndicate organized Calbrico Petroleums Limited, an Alberta company, to which, for a consideration of 1,000,000 shares in its capital stock, they transferred certain oil properties and oil interests they had acquired at a cost of $14,240, of which the appellant had contributed $7,120. No income tax was assessed against him in respect of the portion of the 1,000,000 which he received.

The appellant became the vice-president and managing director of Calbrico. His duties consisted of supervising drilling activities, acquiring oil interests and raising capital

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through brokerage houses. The company reimbursed him for out-of-pocket expenses but he received no remuneration by way of regular salary.

The 1,000,000 Calbrico shares allotted to the appellant and his partner were deposited in escrow with the Prudential Trust Company Limited. After bonusing the brokerage offices which underwrote a public issue of Calbrico shares, the appellant retained a balance of 445,500 escrow shares. He and his partner also subscribed for 187,000 shares at 18¾ cents per share.

Calbrico Petroleums participated in a number of drilling operations but met with no success. The treasury became depleted and the company dormant. In January 1952 Maynard J. Davies, representing a group of shareholders who wished to gain control of Calbrico, approached the appellant with a view of purchasing his shares. On January 24, 1952 the appellant and Davies entered into an agreement which, after reciting the appellant is the owner of 76,266 free shares and 445,500 escrow shares of Calbrico, provides, *inter alia*, that:

(*a*) on payment of a consideration of $10,000 the appellant will transfer 395,500 of his Calbrico escrow shares to Davies;

(*b*) forthwith after payment of the $10,000, the appellant will transfer ten Calbrico free shares to Davies and appoint him as proxy, until such time as the escrow shares are delivered to the parties entitled thereto or default made by Davies, to vote all his (the appellant's) escrow and free shares at all general meetings of Calbrico;

(*c*) Davies shall have the right to purchase, on or before April 23, 1952, at 18¾ cents per share, all or any of the appellant's free shares in Calbrico;

(*d*) Davies shall pay the appellant the sum of $1,000 in full settlement of all his claims as a creditor of Calbrico; and

(*e*) Davies shall use his best endeavours to obtain from Calbrico a release of any claim it may have against the appellant.

As a result of this agreement the Davies group obtained control of Calbrico. This transaction is the third item involved in the appeal.

The appellant had engaged in oil ventures other than the two above described. In 1948 he was a member of the Red Deer Oil Syndicate from which he derived a profit and on which he paid tax. He also purchased a royalty interest in a well being drilled by a company known as Trans-Empire. The well did not prove successful and his loss of $3,515.64 was allowed as a deduction from income.

Another loss was incurred through the purchase of a royalty interest in a well known as the Big Valley. In 1950 or 1951 he acquired an interest in the Lone Mountain—Murray River Syndicate, then developing oil acreage in British Columbia.

In 1952 the appellant and another member of the P. C. M. syndicate incorporated Basco Petroleums Limited. He became the president and managing director of that company and retained both offices until December 1959. While Basco had its principal operations in the north-eastern sections of British Columbia, it also acquired interests in oil properties situated in Alberta and Saskatchewan.

On his 1950 income tax return the appellant listed his occupation as "Leasing (oil rights)" and his employer's name as Edward P. Lamar. On the 1952 return the occupation is shown as "Oil Management" and his employers are listed as "Various". The appellant says that during the two years he was employed by different parties to obtain leases of petroleum and natural gas rights and that the basis of his remuneration was a per diem fee plus a bonus for every acre leased.

The Minister added to 1950 income the $3,487.75 received by the appellant on the sale to Fox of one-half of one per cent of the working interest under the agreement with McRae Developments but identified it as arising from the sale of "½ of 1% of P. C. M. Royalty."

The $6,500 received on the sale of a further one per cent of the working interest was added to 1952 income, under the description "P. C. M. Royalty." Also added to the 1952 income of the appellant was the sum of $10,000 received on the sale of the escrow shares. From this addition, however, the Minister deducted $7,120 being the cost to the appellant of acquiring the oil properties and interests, the transfer of which was the consideration for the allotment and issue of the escrow shares. The net addition to income in respect of the Calbrico transaction was, therefore, $2,880.

Objections to the $3,487.75 addition to 1950 income and to $9,380 of the additions to 1952 income were filed by the appellant. The Minister confirmed both re-assessments.

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The appellant then appealed to the Tax Appeal Board. The Board dismissed the appeal, holding there was no material difference between the facts herein and in *Sheddy v. Minister of National Revenue.*[1]

The appellant maintains that what he calls his "working interest" in the wells brought into production by McRae Developments was a capital asset; that in order to obtain the benefit of the working interest the syndicate was obligated to pay their share of the exploration and operating cost; that while he was engaged both as a principal and as an agent in handling the sale of oil and gas properties he was not engaged in the business of selling securities or in dealing with working interests; that working interests are a separate and specialized branch of the oil business; that the only working interest the syndicate acquired was in the Imperial Oil—Leduc Calmar farmout; and that the two sales of part of his share in the farmout working interest were isolated transactions.

In respect of the Davies transaction the appellant submits the sale of the Calbrico shares was also the sale of a capital asset and that the $10,000 consideration which he received covered not only the purchase of the 395,000 escrow shares but applied also to the right given Davies to vote his free shares, to the right to purchase his free shares and to the acquisition of Calbrico control. He contends control of the company was the most valuable asset which Davies purchased.

The Minister contends the three transactions in question were part of the occupation in which the appellant was engaged and from which he derived his livelihood and that, so far as liability to income tax is concerned, no distinction can be drawn between the receipts derived from what the appellant terms a net royalty and that which he terms a working interest.

The relevant paragraphs of the agreement between the syndicate and McRae Developments relating to the net royalty and working interest are:

> The cost of drilling the first well shall be borne as follows:—
>
> (*a*) McRae Developments at its own expense shall drill or cause to be drilled the said well to the producing zone in the D-2.

[1] [1959] Ex. C.R. 272; [1959] C.T.C. 132; 59 D.T.C. 1073.

(*b*) Thereafter and if production of the leased substances is obtained in commercial quantities, the parties shall bear the cost of completion in the ratio of 57 by McRae Developments and 20 by the Syndicate.

The cost of drilling the second and all subsequent wells shall be paid out of production in the manner hereinafter prescribed.

McRae Developments shall be the Operator of the said well if it is brought into production and of any other well or wells drilled upon the lands described in the said Farmout Agreement, subject to the approval of Leduc Calmar Oil Company Limited and of Imperial Oil Limited first had and obtained to McRae Developments so acting.

The revenue from production of the first well after payment of the royalty reserved in the original lease, the payment of crude oil to Imperial Oil Limited as reserved in the Farmout Agreement and operating expenses, shall be paid to Prudential Trust Company, 800 Lancaster Building, Calgary, Alberta, and the parties hereto shall instruct the said Trust Company to make payments therefrom as follows:

(*a*) To Leduc Calmar Oil Company Limited	Ten (10%) Per Cent
(*b*) To A. E. Silliker	Three (3%) Per Cent
(*c*) To the Syndicate	Five (5%) Per Cent
(*d*) To W. R. McRae	Five (5%) Per Cent
(*e*) To the Royal Bank of Canada, Main Branch, Calgary, Alberta, until funds sufficient to defray the cost of drilling and completing the second well are accumulated	Seventy-Seven (77%) Per Cent
(*f*) After Clause (*e*) hereof has been complied with, to the Syndicate until it shall have received Twenty (20%) per cent of production from the commencement of production	Forty-One (41%) Per Cent
(*g*) After clause (*e*) hereof has been complied with to McRae Developments until clause (*f*) has been complied with	Thirty-Six (36%) Per Cent
(*h*) And finally after clauses (*e*) and (*f*) have been complied with, to the Syndicate	Twenty (20%) Per Cent
and to McRae Developments	Fifty-seven (57%) Per Cent

Revenue from production from the second well as in paragraph 5 hereof shall be assigned and paid to the Royal Bank of Canada as aforesaid until funds sufficient to defray the costs of drilling and completing the third well are accumulated and the same procedure shall apply to the third and all subsequent wells, and in each case the distribution of revenue from production shall be distributed as in paragraph five (5) hereof.

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The word "royalty" appears in the agreement only in paragraph 5 when reference is made to "the royalty reserved in the original lease." The term "working interest" is not used in the agreement. The receipts of which the syndicate was entitled to a share are described as "The revenue from production."

The appropriate meaning of "royalty" found in the *Shorter Oxford Dictionary* is:

> a payment made to the landowner by the lessee of a mine in return for the privilege of working it.

While I assume the payment to be made by Imperial Oil to the original lessor (landowner) may properly be termed a royalty, I doubt if the term can properly be applied to the share of the production revenue the syndicate was to receive. That share is, in no way, related to the number of gallons of oil that may be pumped or the number of cubic feet of natural gas that may flow from any well drilled on the farmout. The syndicate had no title to the land involved. They merely had the right to drill and deal with any oil production resulting from such drilling. That right was assigned to McRae Developments. If, as and when a well came into production, McRae Developments and the syndicate became partners. They shared in the same proportions in both the payment of expenses and in the distribution of profits.

The five per cent of revenue to be paid the syndicate under clause (*c*) of paragraph 5 is subject to payment of the royalty reserved in the original lease, to the payment of crude oil to Imperial as reserved in the farmout agreement and to operating expenses. The additional 20% of revenue to be paid under clause (*f*) is subject to the same prior charges, but payment of it to the syndicate is deferred until there has been accumulated in the Royal Bank of Canada sufficient funds to defray the cost of drilling and completing a second well. That is the only difference I find in the payments under clauses (*c*) and (*f*).

The right to receive 20% of future revenue is not a capital asset. It represents merely the right to receive possible future income. There is no evidence the sales of part of the working interest included a transfer of any percentage ownership in equipment. If the appellant did acquire

an equity interest in any equipment used in the operation, a write off, or capital cost allowance, would be included in the operating costs payable out of gross revenue.

The language of the agreement between the appellant and Davies does not support the submission the $10,000 paid by the latter was intended to apply to other than the purchase of 395,000 escrow shares. The relevant paragraphs of the agreement with Davies read:

> WITNESSETH IN CONSIDERATION of the mutual covenants and conditions hereinafter mentioned, the parties hereto agree as follows:
>
> 1. As and when the whole or any part of the said escrow shares are released from the restrictions imposed by the said escrow agreement, the Grantor shall transfer the said shares to the Grantee for his sole use and benefit, SAVE AND EXCEPT 50,000 of the said shares which shall remain the property of the Grantor.
>
> 2. IN CONSIDERATION of the above-mentioned agreement to sell the said escrow shares, the Grantee shall pay to the Grantor the sum of TEN THOUSAND ($10,000) DOLLARS of lawful money of Canada within a period of fifteen days from the date hereof.

No consideration is expressed for the appellant's covenants to transfer ten of his free shares to Davies, to appoint him as proxy to vote all the escrow and free shares, and to grant him the right to purchase all or any of the free shares. I must look at the agreement in the language in which it is drawn. It contains no provision on which to base an apportionment of the $10,000 consideration paid by Davies to other than the price of the escrow shares.

The appellant was engaged in the business of dealing in oil interests and oil leases in any way through which a profit might be obtained and in promoting companies having the same objectives.

The syndicate obtained an assignment of the Imperial Oil—Leduc Calmar farmout and entered into an agreement with McRae Developments in the hope of obtaining a profit from the percentages of revenue production to which they were entitled under the terms thereof.

In the course of the promotional aspect of his activities, the appellant organized Calbrico. In consideration for his promotional work and the oil leases the syndicate assigned to the company, the appellant received shares in the capital

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stock of Calbrico which were placed in escrow. The usual expectation of a promoter such as the appellant is to realize a profit from the sale of escrow shares when the escrow terminates. The appellant was paid no salary as managing director of the company. The escrow shares were part of his stock in trade, not an investment.

Sections 3, 4 and 139 (1)(*e*) of the *Income Tax Act*, as they read in 1950 and 1952, are:

> 3. The income of a taxpayer for a taxation year for the purposes of this Part is his income for the year from all sources inside or outside Canada and, without restricting the generality of the foregoing, includes income for the year from all
>
> (*a*) businesses,
>
> (*b*) property, and
>
> (*c*) offices and employments.
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> 4. Subject to the other provisions of this Part, income for a taxation year from a business or property is the profit therefrom for the year.
>
> 127. (1) In this Act,
>
> * * *
>
> (*e*) "business" includes a profession, calling, trade, manufacture or undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade but does not include an office or employment;

In my view the appellant comes within the three above quoted sections of the Act. The amounts realized on the three transactions were income, as contemplated by section 3, derived from a business of the appellant, as contemplated by section 4 and defined by section 127(1)(*e*) to include an adventure or concern in the nature of trade.

The appeal will be dismissed with costs. The re-assessments of income tax made upon the appellant by the Minister will be confirmed.

Judgment accordingly.