Ottawa
1967
June 21-22

BETWEEN:

MARFLO DRILLING COMPANY LIMITED (formerly MARFLO OILS LIMITED) ..... APPELLANT;

AND

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

Income tax—Company's principal business oil production—Leases acquired in 1960 and 1961 and sold in 1963—Sale price included in income for 1963—Whether cost deductible in any year—Income Tax Act, s. 83A(5a) and (5b), am. 1962, c. 8, s. 19.

Appellant company, whose principal business was the production of petroleum and natural gas, acquired two petroleum and natural gas leases in 1960 and 1961 and sold them on October 15th 1963 for $57,700. Appellant conceded that this sum was required to be included in computing its income for 1963 by s. 83A(5b) of the *Income Tax Act* as amended by S. of C. 1962, c. 8, s. 19 but contended that it was entitled to a deduction for some taxation year in respect of the cost or value of the two leases.

Held, appellant was not entitled to a deduction for any year in respect of the cost or value of the two leases.

INCOME TAX APPEAL.

Maurice A. Régnier for appellant.

D. G. H. Bowman and *J. M. Halley* for respondent.

JACKETT P. (orally):—This is an appeal directly to this Court from the assessment of the appellant for the taxation year 1963 under Part I of the *Income Tax Act.*

Pursuant to Rule 150 of the Rules of Court, the parties to the appeal stated questions of law arising in the appeal in the form of a special case for the opinion of the Court.

Before referring to the facts stated by the special case, it is helpful to recall that Part I of the *Income Tax Act* imposes an income tax upon the taxable income for each taxation year of every person resident in Canada (section 2), that a person's taxable income for a taxation year is his "income" minus certain specified deductions (section 3) and that "income" for a year, in so far as a person who has no income source for the year other than a business is concerned, is "the profit . . . for the year" from the business. It is also helpful to have it in mind that the "profit" from a business for a year is, generally speaking, the revenues of

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the business for the year minus the costs, other than capital costs, of earning those revenues. Generally speaking, therefore, the cost of acquiring the capital assets employed in a business operation and expenses related to a period before the business operation was commenced are not deductible in computing the annual profits from a business except to the extent that there exists special provision in the statute authorizing such a deduction.

Applying such principles to the case of a corporation whose business consists in the production of petroleum and natural gas, it would not, generally speaking, be possible to deduct drilling and exploration costs as a cost of earning the revenues from its business of producing petroleum and natural gas in the absence of express authority for such a deduction. Such authority had been granted from time to time on a term basis by provisions that were not inserted in the *Income Tax Act*. In 1955 these provisions were made a permanent feature of the *Income Tax Act* when section 22 of chapter 54 of the Statutes of 1955 added a new section 83A to the statute. Section 83A, as then enacted, read in part as follows:

> (3) A corporation whose principal business is
>
> (*a*) production, refining or marketing of petroleum, petroleum products or natural gas, or exploring or drilling for petroleum or natural gas,
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> ...
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> may deduct, in computing its income under this Part for a taxation year, the lesser of
>
> (*c*) the aggregate of such of
>
> (i) the drilling and exploration expenses, including all general geological and geophysical expenses, incurred by it on or in respect of exploring or drilling for petroleum or natural gas in Canada, and
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> (ii) the prospecting, exploration and development expenses incurred by it in searching for minerals in Canada,
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> as were incurred after the calendar year 1952 and before the end of the taxation year, to the extent that they were not deductible in computing income for a previous taxation year, or
>
> (*d*) of that aggregate, an amount equal to its income for the taxation year
>
> (i) if no deduction were allowed under paragraph (*b*) of subsection (1) of section 11, and
>
> (ii) if no deduction were allowed under this subsection,
>
> minus the deductions allowed for the year by subsection (1) or (2) of this section and by section 28.
>
> ...

(5) In computing a deduction under subsection (1), (3) or (4), no amount shall be included in respect of a payment for or in respect of a right, licence or privilege to explore for, drill for or take petroleum or natural gas other than an annual payment not exceeding $1 per acre.

• • •

Whether or not subsection (3) of section 83A would otherwise have permitted a deduction of a lump sum paid for "a right, licence or privilege to explore for, drill for or take petroleum or natural gas" as being "drilling" or "exploration" expenses, the effect of subsection (5) was to exclude from subsection (3) deductions any amount paid for such a "right..." other than the annual payments referred to therein. See *Western Leaseholds Ltd. v. Minister of National Revenue*.[1]

Section 19 of chapter 8 of the Statutes of Canada of 1962 made certain changes in section 83A (to which changes that do not concern us in this case had been made in the meantime). So far as is relevant, the 1962 amendment reads as follows:

(3) All that portion of paragraph (*c*) of subsection (3) of section 83A of the said Act following subparagraph (ii) thereof is repealed and the following substituted therefor:

"as were incurred after the calendar year 1952 and before April 11, 1962, to the extent that they were not deductible in computing income for a previous taxation year, or"

(4) All that portion of paragraph (*d*) of subsection (3) of section 83A of the said Act following subparagraph (ii) thereof is repealed and the following substituted therefor:

"minus the deductions allowed for the year by subsections (1), (2), (8a) and (8d) of this section and by section 28."

(5) Section 83A of the said Act is further amended by adding thereto, immediately after subsection (3a) thereof, the following subsections:

"(3b) A corporation whose principal business is

(*a*) production, refining or marketing of petroleum, petroleum products or natural gas, or exploring or drilling for petroleum or natural gas,

• • •

may deduct, in computing its income under this Part for a taxation year, the lesser of

(*f*) the aggregate of such of

(i) the drilling and exploration expenses, including all general geological and geophysical expenses, incurred by it on or in respect of exploring or drilling for petroleum or natural gas in Canada, and

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(ii) the prospecting, exploration and development expenses incurred by it in searching for minerals in Canada,

as were incurred after April 10, 1962, and before the end of the taxation year, to the extent that they were not deductible in computing income for a previous taxation year, or

(g) of that aggregate, an amount equal to its income for the taxation year

(i) if no deduction were allowed under paragraph (b) of subsection (1) of section 11, and

(ii) if no deduction were allowed under this section,

minus the deductions allowed for the year by subsections (1), (2), (3), (4), (4a), (8), (8a) and (8d) of this section and by section 28.

. . .

(7) Subsection (5) of section 83A of the said Act is repealed and the following substituted therefor:

. . .

(5) In computing a deduction under subsection (1), (2) or (4), no amount shall be included in respect of a payment for or in respect of a right, licence or privilege to explore for, drill for or take petroleum or natural gas, acquired before April 11, 1962, other than an annual payment not exceeding $1 per acre.

(5a) Where an association, partnership or syndicate described in subsection (4) or a corporation or individual has, after April 10, 1962, acquired under an agreement or other contract or arrangement a right, licence or privilege to explore for, drill for or take in Canada petroleum, natural gas or other related hydrocarbons (except coal) under which agreement, contract or arrangement there was not acquired any other right to, over or in respect of the land in respect of which such right, licence or privilege was so acquired except the right to enter upon, use and occupy so much of the land as may be necessary for the purpose of exploiting such rights, licence or privilege, an amount paid in respect of the acquisition thereof shall, for the purpose of subsections (3b), (3d), (4a), (4b) and (4c), be deemed to be a drilling or exploration expense on or in respect of exploring or drilling for petroleum or natural gas in Canada incurred at the time of such payment.

(5b) Where a right, licence or privilege to explore for, drill for or take in Canada petroleum, natural gas or other related hydrocarbons (except coal) is disposed of by a corporation described in subsection (3b) or an association, partnership or syndicate described in subsection (4) after April 10, 1962, any amount received by the corporation, association, partnership or syndicate as consideration for the disposition thereof shall be included in computing its income for its fiscal period in which the amount was received unless the corporation, association, partnership or syndicate

(a) acquired such right, licence or privilege by inheritance or bequest, or

(b) acquired such right, licence or privilege before April 11, 1962 and disposed of it before November 9, 1962.

. . .

(15) Subsections (1) to (12) and subsection (14) are applicable to the 1962 and subsequent taxation years, and subsection (13) is applicable in the case of any taxation year ending after April 10, 1962.

It is the 1962 amendment to section 83A that gives rise to the only problem that now remains to be decided in this appeal.

The stated case shows that the appellant's principal business at all material times was the production of petroleum and natural gas, that, in 1960 and 1961, the appellant acquired two petroleum and natural gas leases, and that on October 15, 1963, the appellants sold such leases and received therefor $57,700, which amount was the consideration for the disposition of "a right, licence or privilege to explore for, drill for or take in Canada petroleum, natural gas or other related hydrocarbons (except coal)".

It is common ground that these leases were capital assets of the appellant's business and that subsection (5b) of section 83A of the *Income Tax Act,* as amended in 1962, required the amount of $57,700 to be included in computing the appellant's income for the 1963 taxation year as being the proceeds of rights of the kind described in that subsection. It is also common ground that there is no provision in section 83A that permits the appellant to deduct, in computing its income for any taxation year, any amount in respect of the cost of acquisition of such leases or in respect of their value.

The respondent's position is that, while subsection (5b) of section 83A required the $57,700 received for the leases to be included in computing the appellant's income for 1963, the appellant is not entitled to any deduction in computing its income for any year in respect of the cost or value of such leases. The appellant contends that it is entitled to some such deduction.

While other questions were raised by the pleadings and the stated case, as a result of the position taken by the appellant at the hearing, the only questions remaining to be decided are whether the appellant is entitled to make some such deduction as those to which I have referred, and, if so, what deduction is it permitted to make and in respect of what taxation year is it permitted to make it.

While I quite appreciate that the reason that the appellant brought the appeal is that the result of the assessment, and of the position taken by the respondent, is that the appellant is required to pay a tax called an "income tax" on an amount that is not only the proceeds of a capital

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transaction, but is the gross amount of the proceeds of that transaction and not merely the profit from it. The result is so harsh that it is not unnatural that the appellant should strive for some means of avoiding it.

Nevertheless, I do not consider that the appeal is fairly arguable once these difficult statutory provisions are comprehended sufficiently to understand what Parliament did in 1962 in so far as it is relevant to the problems raised by the appeal.

Prior to the 1962 amendment, an oil producing company could include in the computation of the exploration and other expenses the deduction of which was permitted by section 83A annual payments not exceeding $1 per acre paid for a "right, licence or privilege to explore for, drill for or take petroleum or natural gas" (hereinafter called petroleum or natural gas "rights") but could not deduct anything in respect of any lump sum paid for any such rights (section 83A(5)).

The 1962 amendments removed this restriction for the future (section 83A(5a)) and made it possible to deduct any amount paid in respect of the acquisition of petroleum *or* natural gas rights in the computation of the exploration and other expenses the deduction of which was permitted by section 83A. The result of this was to reduce the amount of the income otherwise subject to income tax by the amounts so paid for capital assets. (Such a deduction bears some analogy to the section 11(1)(*a*) deduction allowed for capital cost.) Parliament apparently was of the view that it was only logical that, if the cost of such capital assets was to be deductible in computing income, the proceeds of the disposition of such assets, when sold, should be added back to income. (This would have some analogy to the recapture of capital cost allowance.) Accordingly, at the same time, it was provided that, where petroleum or natural gas rights are sold, "any amount received as consideration for the disposition" is to be included in computing income (section 83A(5b)).

So far as the future was concerned, therefore, the scheme adopted by subsection (5a) and subsection (5b) of section 83A is, in its broad outline, easily understood and lends itself to a rational justification.

The problem arises in connection with the treatment provided in respect of petroleum or natural gas rights acquired before, and disposed of after, April 10, 1962, the cut-off date adopted for the new scheme.

The right to deduct the full "amount paid in respect of the acquisition" of petroleum or natural gas rights in lieu of the "annual payment not exceeding $1 per acre" was made effective in respect of acquisitions after April 10, 1962. (Compare new subsection (5) and subsection (5a) with subsection (5) as it was before the 1962 amendment.) The obligation of bringing into income amounts received as consideration for the disposition of petroleum or natural gas rights was imposed in respect of dispositions after April 10, 1962, unless (*inter alia*) such right was both (a) acquired on or before that date, and (b) disposed of before November 9, 1962.

Harsh as it might appear in the light of the facts of this case, the Parliamentary intention appears to me to be too clear for argument that

(a) where acquisitions took place on or before April 10, 1962, the $1 per acre deduction was to be the only one permitted, and, where acquisitions took place after that day, the right to deduct cost was to be unlimited,

(b) the proceeds of sale of all such rights acquired after April 10, 1962, are to be included in computing income, and

(c) the proceeds of sale of all such rights acquired on or before April 10, 1962, are to be included in computing income unless disposed of in the period between April 10, 1962 and November 9, 1962, or unless they fall within paragraph (*a*) of subsection (5b) of section 83A.

In other words, it seems clear that Parliament decided that it would allow costs of these rights as exploration expenses and would, at the same time, tax proceeds of the disposition of such rights. It also seems clear that in order to meet the point of view that proceeds of disposition should not be taxed where the rights were acquired at a time when costs were not so allowed, a period of almost seven

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months was provided during which such rights could be disposed of without giving rise to taxation of the proceeds of disposition.

Having regard to my view of the statutory scheme adopted in 1962 as just expressed, it follows that the questions of law set out in subparagraphs (*a*) to (*f*) inclusive of paragraph 8 of the stated case are answered in the negative. The remaining questions do not require to be answered.

Out of respect for the argument of counsel for the appellant, I should say that he put forward a submission to the effect that, when Parliament required an amount of a capital nature to be included in computing income, Parliament must have been impliedly treating it as income from a source (in this case the source being the disposition of the capital asset) and, in accordance with general principles, the cost of earning the amounts that are impliedly deemed to be revenues from that source must be set off against such revenues. Had the matter been one where Parliament had simply required that an amount of a capital nature be included in computing income, I should have felt constrained to give the submission, which was put forward very persuasively indeed, very careful consideration. As, however, in my view, there can be no doubt, upon a reading of the 1962 amendments, that the Parliamentary intention was that, in the case of a disposition after November 9, 1962 of petroleum or natural gas rights that had been acquired on or before April 10, 1962, the proceeds of disposition should be included in computing income and that there should be no deduction of any lump sum paid for them, in my view this is not a case in which it can be implied that there was a Parliamentary intention that related costs are deductible.

I propose now to deliver judgment as indicated above. I also propose to deliver judgment that the appeal be dismissed with costs.

I shall, however, defer delivering the latter judgment for one week to provide an opportunity for the parties to make any submission they may wish to make in writing or to seek an opportunity for verbal submissions.