
Calgary 1966 Mar. 30 — Ottawa May 19

BETWEEN:

FARMERS MUTUAL PETROLEUMS LTD. ..... APPELLANT;

AND

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

Income tax—Income Tax Act, R.S.C. 1952, c. 148. Sections 12(1)(a)(b) 83A (3)(c)(i)—Deductions—Company holding mineral rights on oil lands—Legal expenses—Defending title to mineral rights—Drilling and exploration expenses allegedly incurred under agreement.

After its incorporation in 1949, the appellant company acquired mineral rights from owners of prospective oil lands in Saskatchewan.

In exchange, the landowners received shares of the company and a percentage interest in any rentals or royalties received by the company.

The company appealed its assessments for 1959 and 1960 to this Court on several grounds but, following an agreement between the parties, only two issues remained in dispute.

A number of landowners being dissatisfied with the arrangement made with the appellant company, took action in the courts in an attempt to obtain declarations that the agreements made with the company

had been induced by misrepresentation and were accordingly invalid and void The company incurred legal expenses in successfully defending all such actions. The landowners then sought and obtained legislation calling for the establishment of a special board with power to renegotiate contracts when it was shown that landowners had been deprived of their mineral rights through misrepresentation.

The company sought to deduct all its legal expenses from its income, but the Minister refused to allow the deduction which gives rise to the first issue.

The second issue involved an arrangement between the appellant and Scurry-Rainbow Oil Ltd., the major shareholder of the appellant.

In 1959 and 1960 the operator of a joint program invoiced Scurry for its share of the exploration and drilling costs. The appellant was invoiced by Scurry for the same amounts and, during the two years, paid Scurry a total of $200,000. This amount was claimed by the appellant as a deduction under section 83A (3).

The Minister disallowed the deduction on the ground that the drilling and exploration expenses had been incurred by Scurry and not by the appellant.

Held, That the appellant company was not entitled to the deduction claimed under section 83A(3) What the appellant paid for and received under its agreement with Scurry was the transfer of an interest in lands, it did not pay any exploration and drilling expenses.

2. That the company's legal expenses were payments on account of capital made "with a view of preserving an asset or advantage for the enduring benefit of a trade" within the test so propounded by the Supreme Court of Canada in *M.N.R. v. Dominion Natural Gas Co. Ltd.* [1941] S.C.R. 19.

3. That the 1959 agreement did not effect an assignment of Scurry's interest in the pooling agreement to the appellant but that interest, and the obligation to contribute a share of the expenses, were retained by Scurry.

4. That the legal expenses incurred in making representations respecting proposed legislation and in dealing with the Board were incurred for basically the same purpose and were also capital expenditures within the meaning of section 12(1)(*b*).

5. That the appeal on the two issues remaining in dispute was dismissed. The assessments were referred back to the Minister for reassessment in accordance with the agreement between the parties.

APPEAL from assessment of the Minister of National Revenue.

J. H. Laycraft, Q.C. for appellant.

D. G. H. Bowman and *R. F. Lindsay* for respondent.

CATTANACH J.:—These are appeals from the appellant's income tax assessments for its 1959 and 1960 taxation years.

1966

FARMERS MUTUAL PETROLEUMS LTD. v. MINISTER OF NATIONAL REVENUE

Cattanach J.

Certain of the issues arising in these appeals were settled by consent of the parties, but two issues remain for determination, which issues involve (1) legal expenses incurred by the appellant and (2) expenses alleged by the appellant to have been laid out by it for drilling and exploration for petroleum or natural gas in Canada within the meaning of section 83A of the *Income Tax Act*.

Both such items were disallowed by the Minister as deductions from the appellant's income. The legal expenses were disallowed on the ground that they were outlays on account of capital within the meaning of section 12(1)(*b*) of the *Income Tax Act* whereas the appellant contends that such expenses were incurred for the purpose of gaining or producing income from the appellant's property or business and were not capital outlays. With respect to the drilling and exploration expenses the Minister contends that such costs were incurred by Scurry-Rainbow Oil Limited and not by the appellant.

The appellant was incorporated under the laws of the Province of Saskatchewan as a public joint stock company on December 1, 1949 for the object, *inter alia,* of acquiring mineral rights and exploring for petroleum and natural gas. The authorized capital stock consisted of 1,000,000 shares without nominal or par value, the maximum price or consideration permitted being $1.00 per share.

Forthwith upon its incorporation the appellant began a vigorous and successful campaign to acquire mineral rights from land owners. As a matter of policy the appellant directed its efforts exclusively to acquiring mineral rights from those land owners who had previously granted leases of their petroleum and natural gas rights to other lessees, in all instances a major oil producing company. The leases in effect were uniform and standard. They were for a period of 10 years providing to the land owner an annual rent of 10 cents per acre and reserving a royalty of 12½ percent to the land owner in the event of a producing well or wells being brought into existence.

The land owner was induced by the appellant to transfer to it the entire estate and interest in the mineral rights, to give absolute ownership and control thereof and benefits to be derived therefrom to the appellant, and to assign his benefits under the existing lease to the appellant. In exchange therefor the land owner received one fully paid

share in the capital stock of the appellant for each acre so transferred and a trust certificate in evidence of the land owner's right to receive one-fifth interest in the land and benefits therefrom so transferred to the appellant and held in trust by the appellant for the land owner.

In pursuance of this campaign the appellant acquired the mineral rights in approximately 750,000 acres in south eastern Saskatchewan and issued approximately 2,500 trust certificates. The appellant received as income four-fifths of the rentals payable thereon and four-fifths of any royalties from producing lands.

In 1955 when oil was being discovered in south eastern Saskatchewan the land owners became disenchanted with their arrangement with the appellant and instituted actions in the Court of Queen's Bench of Saskatchewan for declarations that the agreements between them and the appellant were induced by fraudulent misrepresentation and were accordingly void, for orders revesting the mineral rights and the interest in the leases which had been transferred and assigned respectively to the appellant, in and to the land owners.

In all about 250 such actions were begun.

The appellant successfully defended such of those actions as came to trial, in the Queen's Bench, in the Court of Appeal and in the Supreme Court of Canada, so that it remained possessed of the mineral rights and benefits under the contracts above described.

The legal expenses so incurred by the appellant constitute part of the amounts that were claimed by it as a deduction from income and that were disallowed by the Minister.

After the decisions in the Courts became known as favourable to the appellant herein and adverse to the land owners, the land owners who had entered into the arrangements with the appellant and those who had entered into similar arrangements with other companies formed a mineral owners protective association to advocate and obtain legislative relief from their predicaments.

A "Royal Commission on Certain Mineral Transactions" was appointed by the Saskatchewan Government to inquire into allegations that many owners of freehold mineral rights in Saskatchewan had been deprived of such rights by means of fraud or misrepresentation.

1966

FARMERS MUTUAL PETROLEUMS LTD. v. MINISTER OF NATIONAL REVENUE

Cattanach J.

This Commission recommended that a Board be constituted for the purpose of achieving, if possible, the voluntary re-negotiation of contracts whereby the owners were deprived of their freehold mineral rights through misrepresentation, whether innocent or fraudulent.

Chapter 102, Statutes of Saskatchewan, 1959, entitled "The Mineral Controls Renegotiation Act, 1959" was enacted to implement the recommendations of the Commission and established a Board. Any grantor of mineral rights who alleged that he was induced to enter into a mineral contract through misrepresentation on the part of another person as to the purpose and effect of the mineral contract or that the mineral contract was unconscionable could apply to the Board for re-negotiation of the contract upon receipt of which application the Board was authorized to make preliminary inquiries. If as a result of such inquiries the Board was reasonably satisfied that there was *prima facie* evidence of the allegations of the applicant the Board would then renegotiate the contract. If not so satisfied the Board would take no action and notify the applicant accordingly.

This legislation was followed by legislation in 1960 and 1961 extending the time within which applications might be made and providing for the alteration of the terms of such mineral contracts.

The appellant employed counsel to make representations on its behalf to the legislators opposing the proposed legislation, suggesting variations in the terms thereof and making representations to the Board later established pursuant to legislation enacted with respect to contracts entered into by it which were sought to be re-negotiated.

The ultimate result was that the appellant did not lose any of the mineral rights it had acquired by virtue of the contracts it had entered into with land owners and the contracts under which such mineral rights were acquired by the appellant remained substantially in the form in which they were originally negotiated with the land owners.

The appellant claimed as a deduction from income the legal expenses so incurred by it which claim was also disallowed by the Minister.

From the outset the appellant derived income by way of rentals under the leases and royalties from oil and gas

producing lands. During the process of the litigation as to the validity of the mineral contracts the income received was held in trust pending the outcome of the litigation.

In the latter part of 1958 the appellant began to engage in exploration for oil and gas. As the ten year prime leases granted by the land owners to major oil companies expired, the appellant, in agreement with another company, undertook joint exploration and development.

By an agreement dated May 19, 1954, introduced in evidence as Exhibit "6", between Canada Southern Petroleum, Ltd., West Canadian Petroleums Ltd., Canadian Pipe Lines Producers Ltd., Trans Empire Oils Ltd., and British Empire Oil Co., Ltd. it was agreed that the entire legal and beneficial interest in British Columbia crown petroleum and natural gas permits covering approximately one million five hundred thousand acres, would be held jointly.

Scurry-Rainbow Oil Limited (hereinafter referred to as Scurry) became the successor in title to Canadian Pipe Line Producers Ltd., a party to the agreement dated May 19, 1954 and as such held a beneficial interest of 22 percent of the reservations covered by the agreement. Scurry is the major shareholder of the appellant, with some common directors and occupies the same accommodation.

This type of agreement is common in the industry whereby two or more companies join together to conduct exploratory work. The risk incurred is thereby divided. While the same amount of money to be expended by one company remains constant it is extended over a much wider area.

By this agreement the parties thereto agreed to conduct a seismic program and, contingent upon the results thereof, to drill a well on the reservations for the joint account and at the joint expense of the parties thereto in proportion to their respective interests.

A manager-operator was designated being Canadian Southern Petroleum Ltd., which company was succeeded by Phillips Petroleum Ltd.

The manager-operator was given the sole and exclusive management and control of the exploration, drilling and producing operations on the lands.

The agreement contained provisions for the right of the parties to receive information as to progress and to inspect

1966

FARMERS MUTUAL PETROLEUMS LTD. v. MINISTER OF NATIONAL REVENUE

Cattanach J.

and examine the books and records of the manager-operator, for meetings and consultations among the parties, for the surrender, sale or assignment of the whole or any part of a party's interest in the lands.

By an agreement dated January 2, 1959 between Scurry and the appellant, introduced in evidence as Exhibit "7", the appellant agreed to pay all the costs incurred by Scurry in the performance of the seismic program undertaken by Phillips Petroleum Ltd., the manager-operator under the agreement dated May 19, 1954 (Exhibit 6). Upon payment of such costs it was agreed that the appellant shall have neared an undivided three percent (3%) interest in the lands and the interests therein owned by Scurry.

It was also agreed under the agreement between Scurry and the appellant dated May 19, 1954 (Exhibit 6), that after the appellant shall have earned the three percent interest above mentioned by payment of the (22%) twenty-two percent proportion of Scurry under the agreement dated January 2, 1959 with respect to the seismic program, the appellant would have the option to earn an additional eight percent (8%) in the said lands on the condition that the appellant pay the entire proportion of Scurry's costs of drilling a well on the lands.

Under the terms of the agreement dated May 19, 1954 (Exhibit 6), the manager-operator conducted a seismic program in 1959 on the lands in question. In 1960 it continued the seismic program and in addition drilled a well.

The manager-operator invoiced Scurry as a party to the agreement of May 19, 1954 for its twenty-two percent (22%) proportionate share of the seismic and drilling program.

Scurry, upon receipt of its invoice, would in turn invoice the appellant for the amount it was obliged to pay the manager-operator which the appellant would then pay to Scurry. There were twelve such payments in 1959 and 1960, totalling $53,273.38 in 1959 and $145,962.85 in 1960. In ten instances the appellant paid the amounts invoiced to it by Scurry directly to Scurry which Scurry then paid to the manager-operator. In the two other instances Scurry sent the invoices it received from the manager-operator to the appellant and the appellant remitted the amounts thereof to the manager-operator. In no instance was the appellant invoiced directly by the manager-operator.

The foregoing payments represent Scurry's portion of the cost of the seismic program and were paid by the appellant to Scurry as a result of which the appellant became owner of a three percent (3%) interest in the lands.

On October 5, 1959 the appellant by resolution of its directors exercised its option to acquire an additional eight percent interest by paying Scurry's proportionate share of the drilling costs. The payments above mentioned also include the drilling costs so that the appellant became the owner of an additional eight percent (8%) interest in the lands, a total of eleven percent (11%) in all.

By an agreement dated December 18, 1959 Scurry sold ten of its remaining eleven percent interest in the permits to Sunray Oil Company so that the twenty-two percent interest originally held by Scurry became divided as follows: Scurry 1%, the appellant 11% and Sunray 10%.

The reports and information as to progress under the seismic and drilling programs and like information in accordance with the agreement of May 19, 1954 were supplied by the manager-operator to Scurry and because of the close relationship between Scurry and the appellant such information was available to the appellant. In 1960 the appellant expended the sum of $2,381.75 in employing geologists and engineers to inspect the seismic and drilling operations carried on by the manager-operator without objection by the manager-operator but the manager-operator invariably dealt directly with Scurry. By the consent of the parties above referred to this amount is to be allowed as a proper deduction.

With respect to the second issue, the Minister disallowed as a deduction the sums which the appellant paid to Scurry pursuant to the terms of the agreement between the appellant and Scurry dated January 2, 1959 on the ground that they were not drilling or exploration expenses incurred by it on or in respect of exploring or drilling for petroleum or natural gas in Canada within the meaning of subsection (3) of section 83A of the *Income Tax Act*[1] reading as follows:

> 83A. (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, or

[1] [1952] R.S.C., c. 148.

1966

FARMERS MUTUAL PETROLEUMS LTD. v. MINISTER OF NATIONAL REVENUE

Cattanach J.

(b) mining or exploring for minerals,

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

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

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

(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 section,

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

The question for determination is whether the appellant incurred drilling and exploration expenses within the meaning of subparagraph (i) of paragraph (c) of subsection (3) of section 83A as above quoted.

There is no question whatsoever that exploration and drilling work was done by the manager-operator under the agreement of May 19, 1954 and that the appellant paid to Scurry an amount equivalent to the proportionate share of Scurry's obligation under that agreement.

The question which follows from such circumstances is whether Scurry was reimbursed by the appellant for the exploration expenses so incurred by it under the 1954 agreement. In my view the answer to the question posed is dependent upon the proper interpretation of the agreement dated January 2, 1959 between Scurry and the appellant.

Scurry was a party to the agreement of May 19, 1954 and the appellant was not. Therefore, the appellant had neither rights nor obligations under that agreement. While the agreement contained a provision for the sale or assignment, a specific procedure was prescribed. The party desiring to dispose of its interest or any part thereof is obligated to notify the other parties to the agreement who are entitled to purchase the interest desired to be sold upon the identical terms as the interest was offered to the proposed purchaser. The provision contains an exception when the

entire interest is sold to a subsidiary company. The exception does not apply in the circumstances of the present appeals, nor was there any evidence adduced that the foregoing provisions were complied with. Therefore, I assume that they were not. However, the agreement did provide that the provisions thereof should enure to the successors and assigns of the parties thereto.

I cannot construe the agreement of January 2, 1959 between Scurry and the appellant as an assignment, nor does the conduct of the parties lead to that conclusion. The manager-operator invariably looked to Scurry for payment. Information was supplied to Scurry and not the appellant. In short the appellant did not occupy the place and stead of Scurry. There was no contractual relationship between the manager-operator and the appellant, nor were the obligations of Scurry under the 1954 agreement in any way diminished by its 1959 agreement with the appellant. The manager-operator was not the agent for the appellant in expending the amounts on exploration and drilling but remained the agent of Scurry.

The submission on behalf of the appellant, as I understand it, is that by the agreement between Scurry and the appellant dated January 2, 1959 the appellant reimbursed Scurry for its outlay for exploration and drilling expenses. Since an expense cannot be incurred by a party who is truly reimbursed, therefore it cannot be said that the expenses were incurred by Scurry but rather they must have been incurred by the appellant which was out of pocket in the precise amount of the expenses and that Scurry was merely the conduit between the appellant and the manager-operator.

In my opinion the agreement between Scurry and the appellant is not susceptible of such interpretation. The substance of that transaction, as I see it, was that the appellant purchased an interest in lands from Scurry and that the price to be paid therefor was determined and measured by the cost of the exploration and drilling expenses incurred by Scurry. It was a condition precedent to any payment to Scurry by the appellant that Scurry should have incurred exploration and drilling expenses and I can entertain no doubt that the money paid by the appellant to Scurry was in consideration for a transfer of an interest in

1966

FARMERS MUTUAL PETROLEUMS LTD. v MINISTER OF NATIONAL REVENUE

Cattanach J

land from Scurry to the appellant although that consideration was measured by the yardstick of the costs incurred by Scurry. What Scurry received was payment for an asset sold by it to the appellant and accordingly Scurry was not reimbursed for the exploration expenses incurred by it. Conversely what the appellant paid for and received was the transfer of an interest in lands and therefore did not pay for exploration and drilling expenses.

It follows that the appellant is unsuccessful on this issue.

I turn now to a consideration of the first issue of the two issues involved in these appeals, that is, the deductibility of the legal expenses incurred by the appellant as a consequence of the circumstances outlined above. These legal expenses are themselves divisible into two categories: (1) those incurred in defending the law suits brought against the appellant seeking orders revesting the mineral rights and interest in the leases acquired by the appellant in the transferors and (2) those incurred in making representations respecting proposed legislation and, when that legislation became effective, opposing any renegotiation of the contracts entered into by the appellant which were sought to be renegotiated.

The questions so raised are to be determined by a consideration of the facts above outlined and the provisions of paragraphs (*a*) and (*b*) of subsection (1) of section 12 of the *Income Tax Act*[1] which read as follows:

> 12. (1) In computing income, no deduction shall be made in respect of
>
> (*a*) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,
>
> (*b*) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part,
>
> . . .

Section 12(1)(*a*) and (*b*) were derived from section 6(1)(*a*) and (*b*) of the *Income War Tax Act* which provided as follows:

> 6. (1) In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of
>
> (*a*) disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income;
>
> (*b*) any outlay, loss or replacement of capital or any payment on account of capital or any depreciation, depletion or obsolescence, except as otherwise provided in this Act.

[1] 1952 R S C, c. 148

It will be observed that in section 6(1)(*a*) the words "wholly, exclusively and necessarily" appeared and that such words are omitted from section 12(1)(*a*).

In *B.C. Electric Ry. Co. Ltd. v. M.N.R.*[1] Abbott J. said "The less stringent provisions of the new section should, I think, be borne in mind in considering judicial opinions based upon the former sections". I am impelled, however, to point out that section 12(1)(*b*) has been enacted substantially in the language of its predecessor, section 6(1)(*b*).

In *The Royal Trust Company v. M.N.R.*[2] Thorson P., a former President of this Court, had this to say at page 80,

> . . .Thus, it may be stated categorically that in a case under *The Income Tax Act* the first matter to be determined in deciding whether an outlay or expense is outside the prohibition of section 12(1)(*a*) of the Act is whether it was made or incurred by the taxpayer in accordance with the ordinary principles of commercial trading or well accepted principles of business practice If it was not, that is the end of the matter. But if it was, then the outlay or expense is properly deductible unless it falls outside the expressed exception of section 12(1)(*a*), and therefore, within its prohibition

However the primary test of deductibility so outlined is not the sole test. If the outlay in question passes the test of the excepting portion of paragraph (*a*) of section 12(1) its deduction will be denied if it be specifically excluded by any other provision of the Act.

Later in *B.C. Electric Ry. Co. Ltd. v. M.N.R.* (*supra*) Abbott J. also had this to say, "Since the main purpose of every business undertaking is presumably to make a profit, any expenditure made 'for the purpose of gaining or producing income' comes within the terms of section 12(1)(*a*) whether it be classified as an income expense or as a capital outlay."

If, however, these legal expenses were a payment on account of capital then the expenditure thereof by the appellant would be barred as a deduction by the provisions of paragraph (*b*) of section 12(1). If this were so that would end the matter and paragraph (*a*) need not be considered. The question to be decided is thus narrowed down to whether or not these legal expenses were an outlay of capital.

[1] [1958] S C.R. 133 [2] [1956-1960] Ex. C R. 70

1966

FARMERS MUTUAL PETROLEUMS LTD. v. MINISTER OF NATIONAL REVENUE

Cattanach J.

The general principles to be applied to determine whether an expenditure, which might be allowable under section 12(1)(*a*), is an outlay of capital, are now fairly well established.

In *M.N.R. v. Dominion Natural Gas Co., Ltd.*[1] the respondent company had incurred legal expenses in defending its right, under a franchise, to supply gas in the City of Hamilton and sought to deduct such expenses from its income. Duff C.J., for himself and Davis J. held the legal expenses were not deductible on two grounds; one, that they were not expenses incurred in the process of earning the "income", and the other, that the expenditure was a capital expenditure incurred "once and for all" for the purpose and with the effect of procuring for the Company "the advantage of an enduring benefit." Kerwin J. as he then was, speaking for Hudson J. as well, agreed that the payment of the legal costs was not an expenditure laid out as part of the process of profit earning. His view was that it was a "payment on account of capital as it was made (to use Viscount Cave's words) with a view of preserving an asset or advantage for the enduring benefit of a trade". It will be observed that Kerwin J. departs slightly from the words of the classical test laid down by Viscount Cave in *British Insulated and Helsby Cables Ltd. v. Atherton*[2] at page 213 which reads as follows:

> But when an expenditure is made, not only once and for all, but with a view to *bringing into existence* an asset or advantage for the enduring benefit of a trade, I think there is a very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital.

Kerwin J. substituted the word "preserving" for Viscount Cave's words "bringing into existence" but I think it is clear that he did so with the deliberate intention of extending the test of Viscount Cave to include the preservation or protection of an asset or advantage within its ambit. In any event the language used by Kerwin J. was subsequently cited in its precise terms with approval by the Supreme Court of Canada (*vide* Duff C.J. in *M.N.R. v. The Kellogg Company of Canada, Limited*[3]).

All judges of the Supreme Court of Canada have adopted as a useful guide in determining whether an expenditure is

[1] [1941] S.C.R. 19. [2] [1926] A.C. 205.
[3] [1943] S.C.R. 58.

one made on account of capital, the test formulated by Viscount Cave as quoted above. See *Montreal Light, Heat & Power Consolidated v. M.N.R.*[1] affirmed by the Privy Council[2] and *B.C. Electric Ry. v. M.N.R.* (*supra*).

In my view, it is established by the *Dominion Natural Gas case (supra)* that legal expenses incurred by a taxpayer in maintaining the title to this property and by the *Montreal Light, Heat & Power Consolidated case (supra)* that expenses in connection with the financing of his business are not expenses directly related to the earning of his income and are not allowed as deductions in computing the gain or profit to be assessed.

However, the English and Canadian authorities are not in agreement. In *Southern v. Borax Consolidated Ltd.*[3] the taxpayer incurred legal expenses in defending the title to real estate in California owned by one of its subsidiaries but which for income tax purposes was considered to be carrying on the business of the taxpayer. The Commissioner held the monies paid were laid out for the purpose of the trade. This decision was held to be right by Lawrence J. who said at page 120:

> It appears to me that the legal expenses which were incurred by the respondent company did not create any new asset at all, but were expenses which were incurred in the ordinary course of maintaining the assets of the company and the fact that it was maintaining the title and not the value of the company's business does not, in my opinion, make it any different.

Reference was also made to *Morgan v. Tate and Lyle Ltd.*[4] where the taxpayer had expended a large amount in a campaign opposing the nationalization of its sugar business. It was held that the sums were deductible as monies spent to preserve the very existence of the company's trade. *Southern v. Borax Consolidated Ltd.* (*supra*) was therein cited with approval as well as a statement by Lord Greene, M.R. that "the money you spend in defending your title to a capital asset, which is assailed unjustly, is obviously a revenue asset".

But in *Siscoe Gold Mines v. M.N.R.*[5] Thorson P. the then President of this Court, declined to follow the decision in the *Borax case (supra)* in view of the principles laid down in the *Dominion Natural Gas Company case (supra)*

[1] [1942] S.C.R. 89.
[2] [1944] A.C. 126.
[3] [1941] 1 K.B. 111.
[4] [1955] A.C. 21.
[5] [1945] Ex. C.R. 257.

1966

FARMERS MUTUAL PETROLEUMS LTD. v. MINISTER OF NATIONAL REVENUE

Cattanach J.

and the *Montreal Light, Heat & Power Consolidated case (supra)* which are binding on this Court. He held that the legal expenses incurred by the taxpayer therein in maintaining the title to certain mining properties were not expenditures directly related to the earning of his income, but rather considered them to be capital outlays or payments on account of capital and as such within the prohibitions of section 6(*b*), now section 12(1)(*b*).

Counsel for the appellant placed much reliance on the decision in *Evans v. M.N.R.*[1] reversing a decision of this Court[2]. The appellant spent a considerable amount in a successful effort to convince the courts that she was entitled to an annual income from her late father-in-law's estate. The Minister refused to allow the deduction of the fees so paid on the ground that they were a payment on account of capital within the meaning of section 12(1)(*b*). Cartwright J. speaking on behalf of the majority, held that the appellant's claim in regard to which the expenses were incurred was a claim to income to which she was entitled and accordingly the expenses were properly deductible as having been incurred to obtain payment of that income. In reaching that conclusion Cartwright J. pointed out that the appellant had the right for her life-time to be paid the income from one-third of the estate, the legal ownership of which remained in the trustee; that her right was solely to require the trustee to pay the income arising from the estate to her and that the payment of the legal fees did not bring this right into existence but rather that her right arose from the will of which she was beneficiary and not from the judgment of the court. He also pointed out that the mere fact the right could be sold or valued on an actuarial basis did not constitute the right a capital asset.

Counsel for the appellant frankly admits that the mineral rights here involved are capital assets but points out that they also have an income aspect. The appellant, by its preconceived policy of taking transfers of mineral rights, which were subject to leases under which rentals were payable, thereby assured itself of income in the form of rentals under the leases. In this respect he sought to distinguish the *Dominion Natural Gas case (supra)* in that the franchise there involved did not of itself yield any income to the company which held it.

[1] [1960] S.C.R. 391.

[2] [1959] Ex. C.R. 54

In *M.N.R. v. Goldsmith Bros., Smelting and Refining Co. Ltd.*[1] Rand J. explained the judgment in *Dominion Natural Gas (supra)* as having been based on the view that the legal fees there in question were "expenses to preserve a capital asset in a capital aspect."

In the present appeals, counsel for the appellant points out that in addition to the capital aspect there was also an income aspect involved.

In commenting on the *Dominion Natural Gas case (supra)* Cartwright J. had this to say in the *Evans case (supra)*:

> The "asset" or "advantage" under consideration in *Dominion Natural Gas* was a valuable, exclusive perpetual franchise; this franchise did not of itself yield any income to the Company which held it; it was a permanent right used and useful in the earning of the company's income by the sale of its product to the persons residing in the territory covered by the franchise; it was rightly regarded as an item of fixed capital.

The distinction between circulating and fixed capital is set forth by Lord MacMillan in *Van den Berghs Ltd. v. Clark*[2] in these words:

> Circulating capital is capital which is turned over, and in the process of being turned over yields profit or loss Fixed capital is not involved directly in that process, and remains unaffected by it.

I cannot escape the conclusion that the items involved in these appeals are items of fixed capital. They were interests in lands, they were carried as such in the appellant's balance sheet and most significantly they were not traded in. The income received by the appellant was income from property and that property is therefore a fixed capital asset.

While it is true as Abbott J. pointed out in the *B.C. Electric Ry. Co. Ltd. case (supra)* that since the purpose of every business undertaking is presumably to make a profit and so every expenditure in respect of a business is directed to that end, nevertheless the distinction still remains to be made whether the expense is a current expense or a capital outlay. The coal that a coal merchant buys and sells in the course of his trade, is his circulating capital, but if, instead of buying his coal from outside sources he purchases a coal mine, it seems clear to me that the purchase of the mine is not a purchase of coal, but a purchase of land with the right of extracting coal from it and the land constitutes part of his fixed capital.

[1] [1954] S.C.R. 55. [2] 19 T.C. 390.

1966

FARMERS MUTUAL PETROLEUMS LTD. v. MINISTER OF NATIONAL REVENUE

Cattanach J.

I can perceive no distinction between the assets acquired by the appellant herein and the coal mine purchased by the supposititious coal merchant in the above circumstances.

Without the mineral rights transferred to the appellant and the leases assigned to it the appellant's whole business comes to nought.

In the numerous actions brought against the appellant, title defects were alleged. If the actions were successful the appellant would have been deprived of all its assets. In my view the effect of the appellant's defence of these actions was to establish an uncontroverted legal title to those assets. The purpose was to repel an attempt to deprive it of its property and not to protect a right to income except incidentally. As a result of the appellant's successful defence of this litigation, it emerged with its titles intact.

Therefore I am of the opinion that the legal expenses incurred by the appellant in defending the actions brought against it were a "payment on account of capital" made "with a view of preserving an asset or advantage for the enduring benefit of a trade" within the test so propounded by Kerwin J. in the *Dominion Natural Gas case* (*supra*).

I do not think that the effect of that case on the facts of this case is altered by the subsequent decisions of the Supreme Court in *M.N.R. v. The Kellogg Company of Canada, Limited* (*supra*), *M.N.R. v. Goldsmith Bros. Smelting and Refining Co., Ltd.* (*supra*) or *Evans v. M.N.R.* (*supra*).

In the *Kellogg case*, Duff C.J. held that "the right upon which the respondents relied was not a right of property, or an exclusive right of any description, but the right (in common with all members of the public) to describe their goods in the manner in which they were describing them." The Chief Justice pointed out that the payment of the cost of the legal expenses in the *Dominion Natural Gas case* (*supra*) was not an expenditure "laid out as part of the process of profit earning", but was an expenditure made "with a view of preserving an asset or advantage for the enduring benefit of a trade", and, therefore, capital expenditure. No reflection whatsoever was cast upon the correctness of that decision.

In the Goldsmith Bros. case legal expenses were incurred in a successful defence against charges laid under the

Combines Act. Such legal expenses were held to have been expended to defend their trade practices and the payment thereof was therefore a beneficial outlay to preserve what helped to produce income. The legal fees so paid were necessary in a commercial sense and were wholly and exclusively laid out or expended for the purpose of earning the income within the meaning of section 6(1)(*a*) whereas the *Dominion Natural Gas case* (*supra*) was distinguished as having been a case of expenses to preserve a capital asset in a capital aspect.

Similarly in the *Evans case* (*supra*) the right involved was held to be a right to income which was being wrongfully withheld by the trustee in whom legal ownership was vested. It followed therefore that the legal expenses were incurred to collect that income and was accordingly an expense within section 12(1)(*a*). Again the *Dominion Natural Gas case* was distinguished in that the franchise there sought to be protected was rightly regarded as an item of fixed capital.

While the foregoing remarks have been directed to those legal expenses incurred in the successful defence of the court actions brought against the appellant, I am of the opinion that the same considerations apply to those legal expenses incurred in making representations respecting the proposed legislation and in appearing before the Board set up when the legislation came into effect to oppose the renegotiation of the contracts entered into by the appellant with land owners.

The basic purpose of the appellant in making such representations was, in my view, identical to that for which it defended the litigation against it, that is to preserve its capital assets intact and this the appellant, in the result, succeeded in doing. Therefore, these expenditures, too, should be regarded as outlays on account of capital within the meaning of section 12(1)(*b*) and their deduction is accordingly prohibited thereby.

The appellant is, therefore, also unsuccessful on this issue in its appeals.

At the outset of the hearing of these appeals the parties by their respective counsel agreed to settle certain of the issues as follows:

1. The parties hereto consent to judgment allowing in part the appeal for the 1960 taxation year and referring the assessment back to the

1966

FARMERS MUTUAL PETROLEUMS LTD v MINISTER OF NATIONAL REVENUE

Cattanach J.

Minister of National Revenue for reassessment for the purposes of allowing as a deduction under s 83A(3) of the *Income Tax Act* the sum of $2,381.75 referred to in paragraph 16 of the 1960 Notice of Appeal.

2. The parties hereto consent to judgment allowing the appeals from the assessments for the 1959 and 1960 taxation years and referring the assessments for those years back to the Minister of National Revenue for reassessment on the basis that such portions of the sums of $9,199.00 (referred to in paragraph 12 of the 1959 Notice of Appeal) and of $15,310.53 (referred to in paragraph 13 of the 1960 Notice of Appeal) as were paid in each of the 1957 to 1960 taxation years, may be deducted in computing the Appellant's income in the years in which the said portions were paid. It is further agreed that to the extent that any part of the said amounts were paid in years prior to the 1959 taxation year the appropriate adjustment will be made to the 1959 and 1960 assessments for the purpose of giving effect to the provisions of s 27(1)(*e*) of the Income Tax Act.

The parties agreed that there are to be no costs to either party with respect to the issues which were settled by agreement.

Accordingly the assessments for the 1959 and 1960 taxation years are referred back to the Minister for reassessment in accordance with the agreement between the parties. Subject thereto the appeals are dismissed.

The Minister shall be entitled to his costs of the appeals except any cost related exclusively to the issues that were settled by agreement.