Calgary 1966 Mar 30 — Ottawa May 19

BETWEEN:

FREEHOLDERS OIL COMPANY LIMITED ..... APPELLANT;

AND

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

Income tax—Income Tax Act, R.S.C. 1952, c. 148, Section 12(1)(a)(b)—Legal expenses—Revenue expenditure vs. capital expenditure.

This appeal was heard immediately following that of *Farmers Mutual Petroleums Ltd. and The Minister of National Revenue, ante p. 1126.* The sole issue concerned the deductibility of legal expenses in circumstances substantially the same as in the *Farmers Mutual Petroleums Ltd.* case.

Held, That for the same reasons, as in the *Farmers Mutual Petroleums Ltd.* case, the legal expenses were payments on account of capital.

2. That the appeal was dismissed subject to the allowance of certain items as agreed between the parties.

APPEAL from assessments of the Minister of National Revenue.

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

D. G. H. Bowman for respondent.

CATTANACH J.:—These are appeals from assessments to income tax for the appellant's 1959, 1960 and 1961 taxation years.

At the outset of the trial the parties hereto, by their respective counsel, agreed to the settlement of certain of the issues arising in these appeals as follows:

1. The parties hereto consent to judgment allowing in part the appeal from the assessment for the 1960 taxation year and referring the said assessment back to the Minister of National Revenue for reassessment for the purpose of deducting in computing the Appellant's income for the 1960 taxation year the sum of $630 30 referred to in paragraph 11 of the 1960 Notice of Appeal

2. The parties hereto consent to judgment allowing in part the appeals from the assessments for the 1959, 1960 and 1961 taxation years and referring the said assessments back to the Minister of National Revenue for the purpose of allowing as a deduction in the years paid such portion of the sum of $27,584 94 (referred to in paragraph 13 of the 1961 Notice of Appeal) as was paid in each of the said taxation years 1959, 1960 and 1961.

The sole issue remaining in controversy between the parties is with respect to the deductibility of legal expenses incurred in defending actions brought against the appellant disputing the validity of mineral leases entered into between the appellant and the landowners in circumstances closely parallel to those entered into between Farmers Mutual Petroleum Limited (hereinafter referred to as "Farmers Mutual") and certain landowners.

The appeals of Farmers Mutual were heard immediately prior to the hearing of the present appeals. The argument of counsel directed to the deductibility of legal expenses in the appeals of Farmers Mutual were adopted by them as applying to the present appeals with such variation as was dictated by minor differences in the facts of the respective sets of appeals.

There is no substantial difference between the issue here involved and the issue of deductibility of legal expenses in the Farmers Mutual appeals.

In the case of Farmers Mutual the landowner held the mineral rights in fee simple which rights were transferred

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to Farmers Mutual. Further, Farmers Mutual, as a preconceived policy, only dealt with those landowners who had already granted a mineral lease to other oil exploration and producing companies and the arrangement was that four-fifths of the rental income accrued forthwith to Farmers Mutual. The rights of the landowners, who transferred their mineral rights were as beneficiaries under trust certificates evidencing their right to own shares in the capital stock of Farmers Mutual, one-fifth of the rentals and one-fifth of the royalties on oil or gas producing lands accruing to Farmers Mutual.

In the case of the present appellant, (sometimes referred to herein as Freeholders) the landowner retained the fee simple to the mineral rights throughout.

Freeholders, like Farmers Mutual, was incorporated under the laws of the Province of Saskatchewan, and like Farmers Mutual vigorously campaigned to obtain mineral rights from landowners in Saskatchewan, but unlike Farmers Mutual did not obtain transfers of the fee simple in mineral rights, nor did it restrict its dealings to landowners who had previously granted leases of their mineral rights to other lessees.

Freeholders proceeded to acquire leases of mineral rights (1) from landowners, some of whom had not granted leases of those rights and (2) some of whom had already done so. The greater number of the leases acquired by Freeholders were in the second category above.

With respect to the first category (i.e. no prior leases) Freeholders would obtain the grant of a mineral lease for a term of 99 years renewable at Freeholder's option. The consideration paid by Freeholders for such a lease consisted of the allotment to the lessor of one fully paid share in its capital stock for each acre of land involved. It also covenanted to pay and deliver to the lessor an undivided one-fifth of the benefits or proceeds received by Freeholders from any disposition made by it of such minerals.

With respect to the second category (i.e. where prior leases existed), Freeholders would take from the landowner an assignment of the royalties payable to him under his existing lease together with a 99 year lease running from the date of the assignment, which, however, would only take effect upon the termination of the existing lease. The

consideration from Freeholders for such an assignment consisted of a covenant for the allotment of one fully paid share in its capital stock for each acre of land involved, of which one-half of the shares would be allotted forthwith and the other half only when the mineral lease to Freeholders should take effect. Freeholders was to have the right to deal with and dispose of the assigned royalties, but covenanted to pay to the assignors one-fifth of the benefits received by Freeholders from such dispositions.

The campaign for the acquisition of mineral rights and royalties for Freeholders was completed by August 1950. By that time it had acquired leasehold interests in some 23,000 acres and assignments of royalties in respect of previously leased lands of approximately 613,000 acres.

Freeholders received income during the taxation years in question. It first received income from royalties and as the leases producing royalties expired it then drilled oil and gas wells on the leases then vested in it from which wells it also derived income.

In 1955 when the prospect of discovering oil became more likely, the farmers, as did those in the Farmers Mutual case, became disenchanted with their agreements. The landowners instituted actions for an order declaring that the interests granted to Freeholders by such landowners were invalid and void. As was the case of Farmers Mutual, Freeholders successfully defended those actions against it and Freeholders was also successful, in actions instituted by it, in substantiating caveats filed by it.

There were approximately 100 separate law suits.

Pending the outcome of the litigation the monies received by Freeholders from royalties and from the production of oil and gas were paid to a trust company to be held by it for distribution to the persons entitled thereto following the decisions of the court. As Freeholders was successful in the litigation the monies so deposited in trust were ultimately paid to it.

Freeholders also incurred legal expenses in connection with the renegotiation legislation as were incurred by Farmers Mutual in circumstances similar to those outlined in the reasons for judgment in that Company's appeals.

For the reasons which I have outlined in the appeals of Farmers Mutual, which are being filed concurrently with the reasons for judgment herein, I am of the opinion that,

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the legal expenses incurred by Freeholders in defending the actions brought against it and in prosecuting those actions instituted by it to preserve caveats lodged by it, as well as those expenses incurred in making representations respecting the proposed renegotiating legislation and in appearing before the Board set up when that legislation came into effect to oppose the renegotiation of contracts entered into between Freeholders and landowners, were payments on account of capital.

Accordingly, the assessments for the 1959, 1960 and 1961 taxation years are referred back to the Minister for reassessment in accordance with the agreement between the parties. Subject thereto the appeals are dismissed.

As the parties agreed that there are to be no costs to either party with respect to those issues that were settled by agreement, the Minister will be entitled to his costs of the appeals, except any cost related exclusively to the issues that were settled by agreement.