

1939
 {
 Sept. 18.
 —
 1940
 March 11.
 —

BETWEEN :

B & B ROYALTIES LTD.....APPELLANT;

AND

THE MINISTER OF NATIONAL
REVENUE

RESPONDENT.

Revenue—Income—Income War Tax Act, R.S.C., 1927, c. 97, s. 2 (h) & s. 3—“Annual net profit or gain . . . directly or indirectly received by a person . . . from any trade, manufacture or business”—“Association”—“Net royalties” or “units of production” sold to investors by a company engaged in the business of drilling for and taking oil from certain specified lands.—Proceeds of such net royalties or units of production are not taxable as income of the company.

Appellant is engaged in the business of drilling for and taking oil from certain land in the Province of Alberta. It sold to investors a specified percentage, share or interest, in the production or in the net proceeds of production of a certain tract of land. Such percentage share or interest is referred to as a “net royalty” or “unit of production” and is evidenced by written certificates issued to the investor by a Trustee to which appellant assigned 80% of all production from that particular tract of land.

Payment for the sale of the oil produced was made to the Trustee and it accounted to the royalty certificate holders and to appellant therefor.

There were in all 100 units of production and of these there were sold to the public 56½ units for which royalty certificates were issued to the purchasers thereof by the Trustee; 10 units were issued to the original lessee of the land drilled on and 13½ units were allotted to appellant.

Appellant received from the Trustee, on account of its 13½ units, the sum of \$16,059.56, which amount it showed in its income tax return for the taxation period in question. The amount distributed by the Trustee to net royalty holders, other than appellant, was \$79,099.96. The net taxable income of appellant was assessed at \$52,762.02 by the Commissioner of Income Tax. This amount included the sum of \$79,099.96 paid to the other royalty certificate holders and was arrived at after allowing certain deductions for management expenses, depreciation and depletion.

1939
 B & B
 ROYALTIES
 v.
 MINISTER
 OF
 NATIONAL
 REVENUE.
 Maclean J.

This assessment was affirmed by the Minister of National Revenue, from whose decision an appeal was taken to this Court.

Held: That there was an irrevocable alienation by appellant to the Trustee, for a consideration paid, of a stated percentage of any production secured, or the proceeds of that production when sold, less certain deductions, and such percentage of production or the proceeds of that production was not a net profit or gain to appellant.

2. That the appellant and the owners of royalty interests do not form an "association" as defined by the Income War Tax Act.

APPEAL under the provisions of the Income War Tax Act from the decision of the Minister of National Revenue.

The appeal was heard before the Honourable Mr. Justice Maclean, President of the Court, at Calgary, Alberta.

E. J. Chambers, K.C. for appellant.

C. J. Ford, K.C. for respondent.

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

THE PRESIDENT, now (March 11, 1940) delivered the following judgment:

This is an appeal from a decision of the Minister of National Revenue in which he declared the net taxable income of the appellant, hereinafter to be called "the Company," to be \$52,762.02, for the fiscal year ending November 30, 1938.

The question for determination is the amount received by the Company as net profit or gain, during the taxation period in question, from the sale of petroleum and natural gas recovered from a well drilled by the Company on certain lands in the Province of Alberta, pursuant to the terms of a lease assigned to the Company, the particulars of which will appear later. The case is one of considerable interest and importance and is not without its difficulties, and consequently it will be desirable to review at some length the main facts leading to the issue to be determined.

1939
 B & B
 ROYALTIES
 v.
 MINISTER
 OF
 NATIONAL
 REVENUE.
 Maclean J.

The controversy here emerges from a method sometimes resorted to by lessees of oil lands in the Province of Alberta, for securing, wholly or partially, the capital required for proving, drilling and bringing into production, oil wells in the oil bearing areas of that Province. This method involves the sale to investors of what are referred to variously as "royalty interests," "net royalties," "units of production," "percentages of production," or "fractional interests in production," that is to say, a specified percentage, share or interest, in the production or in the net proceeds of production of a certain oil well, or certain oil wells, or from a certain tract of land, as the case may be. The royalty interests so sold are usually evidenced by written certificates issued to the investor.

A lease of oil lands ordinarily stipulates the duration of the same, the terms of its renewal, the period within which drilling must be commenced by the lessee, and the percentage of production, called a "gross royalty," to be received by the original landowner or lessor, when and after production begins. The anticipated production of an oil well is divided by the lessee into one hundred units, each unit being one per cent of the production or yield, and, after making provision for any "gross royalties," these units of production, or some of them, are sold to the public, and are usually referred to as "royalties," or "net royalties." The term "royalty," I think, more properly applies to the interest in production reserved by the original lessor by way of rent for the right or privilege of taking oil or gas out of a designated tract of land, and such interest is not subject to deductions for operation, maintenance and management charges, by the lessee, and it is for that reason that such an interest is usually referred to as "a gross royalty." The remaining interests in production which are sold to the public in order to obtain capital, only participate in production after operating and management expenses, and other charges, are deducted and hence are usually referred to as "net royalties." It will be convenient, however, to continue the use of the terms "net royalties," or "royalty interests," in the sense they were used by the Company in this case.

In the working out of this method of financing the drilling of an oil well, and before net royalties or royalty interests in production are sold to the public by the

lessee of oil lands, it is, in some cases at least, the practice for the lessee to select a trustee, and to enter into an agreement with such trustee, on behalf of the lessee and of all those who may become interested as purchasers of net royalties, in the general terms which I am about to state. To the trustee there is then assigned all, or a certain percentage, of the oil recovered from the leased lands, or from a defined portion of such lands; or, it may be a percentage of the oil to be recovered from one designated well, located on the leased lands. In the case under discussion a trustee was selected by the lessee, and an assignment of that character was made to the trustee by the lessee, the particulars of which I shall describe presently. As I understand it, the oil, as and when produced, is usually sold by the lessee to some oil purchasing agency, evidenced by a contract in writing, with or without consent of the trustee according to the terms of the trust agreement, and, unless otherwise provided, the proceeds of such sale would be payable to the lessee and by him, subject to certain deductions, to the trustee, as provided by the trust instrument, or, if so provided by the contract of sale, or the trust instrument, the proceeds might be paid directly to the trustee by the purchaser, and the trustee would then account for the same to the lessee and those interested in the net royalties. Such trust agreements would, of course, vary in their terms, but the above describes broadly the method resorted to by the Company in this case, in financing its operations.

I may now turn to the particular facts of this case as they developed from time to time. In 1917, the Crown represented by the Minister of Interior of Canada, leased to one Robert Williamson Brown certain described lands, situate in the Province of Alberta, for the sole and only purpose of mining and operating for petroleum and natural gas, and of laying pipe lines and of building tanks, stations and structures thereon necessary and convenient to take care of the said products. When the natural resources were conveyed to the Western Provinces, in 1929, the title to the lands described in that lease passed to the Crown in the right of the Province of Alberta, at least I am assuming that to be so. The lease was for the term of twenty-one years, subject to the rents, royalties, conditions and covenants therein set forth; while it would

1939
 B & B
 ROYALTIES
 v.
 MINISTER
 OF
 NATIONAL
 REVENUE.
 Maclean J.

1939
 B & B
 ROYALTIES
 v.
 MINISTER
 OF
 NATIONAL
 REVENUE.
 Maclean J.

appear that the lands so leased were the subject of two separate leases they may be regarded here as one lease, hereafter to be referred to as the "Head Lease" and the grantor as the "Head Lessor." The lessee covenanted to pay to the Head Lessor a royalty on all natural gas and petroleum products taken out of the said lands, at such rate as might from time to time be specified by Order in Council; and this it is agreed was a gross royalty of ten per cent, in kind or in money at the option of the Head Lessor, of all commercial production recovered from the said lands, and free from all manner of deductions whatsoever.

On July 4, 1936, the said Robert Williamson Brown, by indenture, sublet to one Robert Arthur Brown a portion of the lands covered by the Head Lease for the balance of its term, subject to all the terms and conditions therein expressed. The consideration was \$10,000 in cash, the assumption and payment of the rents and royalties payable to the Crown under the Head Lease, and the payment to the said Robert Williamson Brown of a gross royalty of ten per cent of all commercial production taken from the said lands pursuant to the Head Lease, and recovered, saved and marketed therefrom, which said royalty was to be considered as royalty by way of rent reserved.

On July 6, 1936, the said Robert Arthur Brown assigned and transferred to the Company, B & B Royalties Ltd., all his right, title and interest in the Sub-Lease just above mentioned, for the following considerations, \$10,000 in cash, \$19,998 by the allotment and issuance of 19,998 fully paid up shares of the capital stock of the Company, the assumption and payment of all rents and royalties payable under the Head Lease and the Sub-Lease, and the payment in cash to the said Robert Arthur Brown of a net royalty of 10 per cent of the current market value, at the time and place of production, of all production of petroleum or natural gas recovered and sold from the lands described in the Sub-Lease.

By an agreement (hereafter referred to as "the Trust Agreement") dated July 8, 1936, and made between the Company, therein called the "Operator," and The Security Trust Co. Ltd., therein called the "Trustee," the Company assigned and set over to the Trustee, subject to certain deductions, 80 per cent of the whole of the

petroleum and petroleum products "produced, taken, saved and sold" from the lands described in the Trust Agreement, and which comprised a portion only of the lands described in the Sub-Lease. The Trust Agreement in part recites:

1939
 B & B
 ROYALTIES
 v.
 MINISTER
 OF
 NATIONAL
 REVENUE.
 ———
 Maclean J.
 ———

AND WHEREAS the Operator is desirous of selling or disposing of certain part or parts of the said rights acquired as aforesaid, but only in respect of the petroleum and natural gas production taken, saved and sold from that part of the lands hereinbefore referred to which comprise the West Half of the South Half of Legal Subdivision Eleven (11) and the East Half of the South Half of Legal Subdivision Twelve of Section Twenty-eight in the Township Eighteen (18), Range Two (2) West of the Fifth Meridian, containing Twenty (20) acres more or less (hereinafter called the "royalty lands") by the creation of royalty interests therein.

AND WHEREAS the Operator and the said Robert Williamson Brown have deposited the said Head Leases and a copy of the said Sub-Lease with The Trusts & Guarantee Company Limited at Calgary, Alberta, under the terms of an Agreement in writing under seal dated the 4th day of July, A.D. 1936, and the Operator has deposited a copy of the said Sub-Lease and a copy of the said Assignment of the said Sub-Lease dated the 6th day of July, A.D. 1936, with the Trustee.

AND WHEREAS the Operator proposes to sell by way of royalty interests a certain part of any production that may be taken, saved and sold by it from the said royalty lands pursuant to the terms of the said Sub-Lease.

AND WHEREAS the Operator has requested the Trustee to act as Trustee on behalf of its and on behalf of all persons, firms and corporations interested in such production under the terms of this Agreement and the Trustee has consented to so act subject to all the terms, conditions, stipulations, covenants and agreements hereinbefore set forth and contained.

NOW THEREFORE THIS AGREEMENT WITNESSETH that in consideration of the premises and of the mutual covenants of the parties hereto, it is agreed by and between the parties as follows:

1. This Agreement shall be known as the "B & B Royalties Number One Trust Agreement," and the royalty trust certificates hereinafter referred to shall mean and include any certificates issued by the Trustee under the terms of this Agreement and such certificates shall be styled and described as "B & B Royalties Number One Trust Certificate" and shall be in the form and style described in the draft certificate attached hereto.

2. The Operator hereby assigns, transfers, conveys and sets over unto the Trustee Eighty (80%) per centum of the whole of the said petroleum, oil, naphtha, gasoline, and/or natural gas produced, taken, saved and sold from the said royalty lands by the Operator, its successors or assigns pursuant to the terms of the said Sub-Lease without any deduction or abatement therefrom whatsoever, except the full actual cost of caring for, delivering and marketing of the said products from and after the time of production from the well to be drilled thereon; of the machinery and equipment used in connection with any well from

1939
 B & B
 ROYALTIES
 v.
 MINISTER
 OF
 NATIONAL
 REVENUE.
 Maclean J.

which production is taken including the necessary separators, tanks, fittings, pipes, valves and appliances and the installation and maintenance thereof; of separating, treating, caring for, extracting and marketing of said production; of surface rights and rights of way; of administration expenses of not more than Two Hundred Dollars (\$200) per month; of all government Municipal or School Taxes or assessments imposed or levied in respect of the said production and equipment and in respect of the lands whereon such well is situated; and of all insurance premiums; it being the intention of the parties hereto that the said Eighty (80%) per centum of the said production as aforesaid shall belong to and be the property of the Trustee for the purposes of this Agreement, less the said deductions and if by reason of the sale of the said production through any pipe line or to any refinery or other consumer, the proceeds of such sale is made direct to the Trustee or if production is taken in kind hereunder by the Trustee, the Trustee shall repay to the Operator therefrom all the said deductions.

3. The Operator hereby covenants, promises and agrees with the Trustee, unless the production deliverable under this Agreement is taken in kind as hereinafter provided, to pay in cash to the Trustee the full Eighty (80) per centum of the gross proceeds of the sale or marketing of the said production, less only the deductions above referred to, on the 25th day of the month next following the month in which production deliverable or payable hereunder shall have been recovered, at the office of the Trustee at Calgary, Alberta.

* * * * *

4. The Operator further acknowledges and agrees that pursuant to the terms of the said Assignment dated the 6th day of July, A D. 1936, of the said Sub-Lease, Robert Arthur Brown is entitled to royalties totalling Ten (10%) per centum as set forth in the said Assignment and that the said royalties of Ten (10%) per centum are included in the royalties of Eighty (80%) per centum hereby assigned and conveyed to the Trustee and hereby authorizes and directs the Trustee to issue Royalty Trust Certificates to the said Robert Arthur Brown or his nominees under the provisions of this Agreement for the said Ten (10%) per centum.

Paragraph 14 of the Trust Agreement may have some importance, and it may be recited in full. It reads:

14. The Operator covenants and agrees with the Trustee that the proceeds of the sale or sales of royalty interests or units hereunder shall be deposited by it in its name in The Royal Bank of Canada, Calgary, Alberta, until the sum of not less than Twenty Thousand Dollars (\$20,000) has been so deposited and shall be considered as a trust fund and in the event that the said sum is not so deposited as the proceeds of the said sale or sales within ninety days from the date hereof, the Operator shall immediately thereafter refund or repay to the respective purchasers of the said royalty interest or units in the sums respectively subscribed, the full amount so paid to the Operator and deposited in the said bank as aforesaid. Unless and until the said sum of Twenty Thousand Dollars is subscribed and deposited as aforesaid no withdrawals from the said account shall be made by the Operator except for the purpose of the said repayment or refund.

Other terms of the Trust Agreement were: that the Company would work the well drilled on the leased lands so long as the same should be shown to yield oil in paying quantities and a profitable market for the same was available; that the Company should permit any person authorized by the Trustee to enter upon the lands and examine any well drilled or being drilled; that the Company would keep true and correct books and records showing the quantity of petroleum products recovered and sold and make such books and records available for the inspection of any person named by the Trustee, and furnish verified returns monthly showing the quantity of petroleum products recovered and saved; that the Trustee should keep proper records of the persons entitled to share in the net royalties, the amount and percentage held by each, and as authorized by the Company, issue to such persons Royalty Trust Certificates, showing therein the interest of such persons in the net royalties; that in the event of production being obtained in paying quantities the Trustee would, within five days of the receipt of the proceeds thereof, distribute the same, less the enumerated expenses and deductions, among those entitled thereto at the time of such distributions; that all moneys realized from the sale of any royalty interest or units, less any commission paid on the sale thereof, should be devoted and used exclusively by the Company for the purpose of the payment of the actual and proper expenses or costs of drilling a well or wells on the leased lands; and that the Trustee might, at the request of the appellant, and with the consent of at least fifty per cent in interest of the royalty certificate holders, approve and confirm any contract made by the appellant for the sale of any production, and that thereupon the terms and conditions of the sale would become binding upon all the holders of royalty certificates, and their assigns. There were certain provisions providing for the event of default by the Company in performing its obligations under the terms of the Trust Agreement but as no such default occurred they need not be mentioned.

The form of the royalty trust certificates prescribed by the Trust Agreement was as follows:

1939
 B & B
 ROYALTIES
 v.
 MINISTER
 OF
 NATIONAL
 REVENUE.
 Maclean J.

1939
 ~~~~~  
 B & B  
 ROYALTIES  
 v.  
 MINISTER  
 OF  
 NATIONAL  
 REVENUE.  
 \_\_\_\_\_  
 Maclean J.

## B &amp; B ROYALTIES No. 1 TRUST CERTIFICATE

This Certifies that .....  
 of the ..... of ..... in the Province  
 of ..... as being entitled to a net royalty  
 of ..... per centum (..... %) of all petroleum  
 natural gas, gasoline gas, naphtha and other petroleum products produced  
 from the first and present well being drilled by B & B ROYALTIES  
 LIMITED on the following lands, namely:

.....  
 subject to all the terms, provisions and conditions of the Trust Agree-  
 ment dated the 8th day of July, A.D. 1936, and subject in particular  
 to the prior charges against the interest of the Royalty Holders here-  
 under as appears by the said Trust Agreement, such charges being gener-  
 ally all production and marketing costs, including equipment therefor,  
 together with the cost of surface rights and the amount of taxes,  
 insurance and administration expenses, and made between B & B Royal-  
 ties Limited as the Operator of the First Part, and The Security Trust  
 Company Limited as the Trustee of the Second Part, which said  
 Agreement may be inspected during office hours at the office of the said  
 The Security Trust Company Limited at Calgary, Alberta. The said  
 royalty is transferable or assignable on the books of the said The  
 Security Trust Company Limited upon surrender of this certificate and  
 upon the execution by the owner thereof of the transfer or assign-  
 ment in the form endorsed hereon or such other form of transfer or assign-  
 ment as may be acceptable to the said The Security Trust Company  
 Limited, and upon the same being properly executed by both the trans-  
 feror and the transferee and delivered to The Security Trust Company  
 Limited, together with payment of its proper transfer fees.

Two further agreements must be referred to. On August  
 1, 1936, two agreements were entered into between the  
 Company and the British American Oil Co. Ltd., one relat-  
 ing to the sale and purchase of crude oil, and the other  
 to natural gas, but a brief reference to the former will  
 suffice. By this agreement the Company agreed to sell,  
 and the British American Oil Company agreed to purchase  
 all the oil produced by the Company from the leased lands,  
 so long as any oil was produced in paying quantities there-  
 from, at the prevailing field prices for a like product, at  
 the time and place of delivery. A condition was attached  
 to the obligation of the British American Oil Company  
 to purchase all of the Company's oil production, but that  
 need not be mentioned. It was also provided that the  
 appellant should furnish to the British American Oil Com-  
 pany divisional orders showing "what share of such oil  
 is payable to any party entitled to royalty oil or other  
 share of production and the purchaser may account directly  
 to such parties for same."

The purpose of furnishing divisional orders was not explained to me but I assume it was primarily a precaution suggested by experience to avoid any conflict in interests in oil sold to pipe line companies or refineries when there must take place a commingling of oil produced by or acquired from different vendors. These orders authorized the British American Oil Company to pay directly to the holders of royalty certificates the share or percentage of the proceeds to which they were severally entitled. In point of fact, I think, payments on account of the sales of production were made by the British American Oil Company directly to the Trustee, and the Trustee accounted to the royalty certificate holders and the Company. I might add that the two agreements above mentioned, for the sale and purchase of the Company's production, were made with the approval of the Trustee, and with the consent in writing of fifty per cent in interest of the royalty certificate holders, as provided for in paragraph 17 of the Trust Agreement.

The Company sold to the public fifty-six and one-half ( $56\frac{1}{2}$ ) units of production, realizing therefrom in cash a sum in excess of \$100,000, and royalty certificates were issued therefor to the purchasers by the Trustee; another ten (10) units were allotted to Robert Arthur Brown pursuant to the assignment of July 6, 1936, and thirteen and one-half ( $13\frac{1}{2}$ ) units were allotted to or retained by the Company. All of those mentioned units would represent 80 per cent of all the production, the net proceeds of which would be distributable among the unit holders, in proportion to their several interests. The remaining 20 per cent of production had been already reserved to the Crown under the Head Lease, and to Robert Williamson Brown under the Sub-Lease.

Coming now to the amount and disposition of the proceeds of the 80 per cent of oil produced and sold by the Company during the taxation period in question. This is succinctly told in a statement of receipts and disbursements issued by the Trustee and made an Exhibit in the cause. I cannot do better than to repeat it. That statement is as follows:

|                                                                                                                                             |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
|---------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1939<br><u>      </u><br>B & B<br>ROYALTIES<br>v.<br>MINISTER<br>OF<br>NATIONAL<br>REVENUE.<br><u>      </u><br>Maclean J.<br><u>      </u> | Receipts:<br><br>Oil Sales ..... \$136,377.51<br>Tail Gas Revenue ..... 1,462.13<br><hr/> \$137,839.64<br><br>Less Gross Royalties paid Province of<br>Alberta ..... \$13,637.76<br>Other ..... 13,783.93<br><hr/> 27,421.69<br><br><hr/> Balance—Total Trustees' Receipts ..... \$110,417.95<br><br>Disbursements—<br>To net Royalty Holders other than B & B Royalties Ld ... .. 79,099.96<br>Operating expenses, General ..... 13,650.08<br>Royalty on Tail Gas & Line Losses..... 900.03<br>Trustees' Fees & Expenses ..... 708.30<br>Net Royalty paid to B & B Royalties Ld..... 16,059.54<br><hr/> Total Trustees' Disbursements ..... \$110,417.95 |
|---------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

From the above statement it will be seen that the Company received from the Trustee as net royalty, on account of its 13½ units, the sum of \$16,059.56, which amount the Company showed as an item of income in its return for the taxation period in question, but this complete return showed a net loss of \$7,350.12, and consequently it was claimed that there was no taxable income. The amount shown to be distributed to net royalty holders, other than the Company, was \$79,099.96, which amount the Minister contends was income in the hands of the appellant before the distribution thereof and, which it is claimed, should have been returned as income received by the Company along with the \$16,059.56. That is the genesis of the dispute here.

The net taxable income of the Company was assessed at \$52,762.02 by the Commissioner of Income Tax, but this amount was reached by including as income of the Company the sum of \$79,099.96 paid to other royalty certificate holders, leaving as net taxable income in the hands of the Company the said sum of \$52,720.02, after certain deductions made on account of management expenses, depreciation and depletion, and which I understand are not appealed from. It was this assessment of net taxable income that was sustained by the decision of the Minister, and from which decision this appeal was asserted. The Company claims that it is only the sum of \$16,059.56 that should enter into the computation of its taxable income,

and that there should not be included therein any of the sums received as net royalties by the other holders of royalty certificates, which sums, it is claimed, were never received, directly or indirectly, as net profit or gain by the Company. The Minister, in his decision affirming the assessment of the Commissioner, claimed, as he also did on this appeal, that all the net proceeds derived from the sale of production were received by the Company, directly or indirectly, as the owner thereof, prior to any payment over to the Trustee for distribution among certificate holders pursuant to the terms of the Trust Agreement, and that the same were therefore to be treated as income received by the Company and consequently liable to the corporation income tax imposed by the Income War Tax Act. It will be seen therefore that the question to be determined is one of principle and not of figures, and that is whether or not the net proceeds received by the holders of net royalty certificates other than the Company, constituted taxable income in the hands of the Company before distribution of the same was made to such holders. If the appellant's view be the correct one it must succeed in its appeal, and if not the assessment appealed from must stand.

Such are the principal facts of the case. The nature of the Trust Agreement is one calculated to raise debatable and difficult questions, and to create situations probably never contemplated by the framers of the Income War Tax Act. The general plan of financing disclosed here, by the sale of percentage interests in production, has long been known in many of the oil producing areas of the United States, with many variations, and many interesting questions have there arisen in connection with income tax cases, but for one reason or other I have been unable to derive any assistance therefrom in determining the issue here before me. One question which has arisen frequently in the United States is whether the proceeds received from the sale of royalty interests constitute income to the lessee. It would seem to be fairly well settled there that where amounts derived from the sale of royalty interests were consumed in drilling the particular well mentioned in the royalty certificates, or in some other document, such amounts did not constitute income to the owner of the lease, but any excess of such moneys paid to the owner

1939  
 B & B  
 ROYALTIES  
 v.  
 MINISTER  
 OF  
 NATIONAL  
 REVENUE.  
 Maclean J.

1939  
 B & B  
 ROYALTIES  
 v.  
 MINISTER  
 OF  
 NATIONAL  
 REVENUE.  
 Maclean J.

of the lease above the cost of the drilling of the well in question constituted income to the lessee. It has been held in several cases that where the taxpayer has been assessed on any moneys received from the sale of royalty interests, the burden was upon him of showing what part, if any, of moneys so received was expended in drilling the specified well or area, and lessees of oil lands have been held liable for the income tax on the total consideration received from the sale of royalty interests where they have failed to show that the same was consumed in drilling the well or area designated. That question however was not raised in this case and I assume the taxing authorities had been satisfied that the moneys received from the sale of royalty interest had been expended in drilling the well referred to in the Trust Agreement. I mention this point only for the purpose of illustrating one of the many difficulties that may arise in income tax cases, under this plan of financing the drilling of oil lands.

One question raised here was whether the assessment should not have been levied against the Company and the royalty certificate holders, as an "association," instead of against the Company alone. An "association," under the Income War Tax Act, is included in the definition of "person." It was submitted by Mr. Ford that if I were of the opinion that the Company and the owners of royalty interests should be assessed as an "association" that I should refer the assessment back to the Minister for further consideration and for formal amendment. Apparently, the assessment of the income in question, upon this basis was considered by the taxing authorities. I was told that if the assessment had thus been levied the total income tax recoverable would have been much higher than if levied against the Company alone, and in fact it was said that the tax, in that event would be quite onerous, and possibly that influenced the taxing authorities in refraining from making the assessment on that basis. I realize that very much can be said for the assessment being made against the Company and the owners of royalty interests, as an "association." However, it appears to me that the arrangement here lacks some of the usual and important characteristics of an "association." I have not been satisfied

that the assessment should have been made against the Company and the owners of royalty interests, as an "association"; at least I presently entertain serious doubts as to whether this could be done successfully. An interesting discussion as to what constitutes an "association," for income tax purposes, is to be found in the American case of *Monrovia Oil Co. v. The Commissioner* (1).

1939  
 B & B  
 ROYALTIES  
 v.  
 MINISTER  
 OF  
 NATIONAL  
 REVENUE.  
 Maclean J.

The important and difficult question here is the construction to be given the Trust Agreement. Did this agreement operate to divest the Company of its beneficial interest in the percentage of production therein mentioned, or in the proceeds of that production, or, is the agreement in substance but a contractual obligation assumed by the Company to pay to those who purchased royalty interests a certain proportion of the net income realized from the sale of oil recovered from a specified oil well? The former result would be an illustration of the alienation of production or its proceeds, and the latter an illustration of the mere application of income, and there is a distinction to be made between the two. The mere application of income in pursuance of an obligation under a contract does not affect the ownership of that income. If the agreement operated to divest the Company of its interest in 80 per cent of the production, then it was alienated, and the proceeds derived therefrom would not, I think, be income in the hands of the Company. In any event, as between the parties, there was an enforceable contract, that is to say, the Trustee could, I think, compel performance of the contract by the Company. The substance of the transaction was, I think, the irrevocable alienation, for a consideration paid, of a stated percentage of any production recovered, or the proceeds of that production when sold, less certain deductions. I think the agreement sought to put the ownership of a percentage of the oil produced in the Trustee on behalf of the purchasers of royalty interests, and the moment the oil was pumped to the surface the legal interest therein passed to the Trustee; prior to that the title to the oil in the ground would probably be in the Head Lessor. That was the construction given the agreement by the parties there-

(1) (1936) 83 Fed. R. (2d) 417.

1939  
 B & B  
 ROYALTIES  
 v.  
 MINISTER  
 OF  
 NATIONAL  
 REVENUE  
 Maclean J.

to, and in that way the agreement was worked out and implemented. The agreement was not attacked by the revenue authorities nor was it alleged to be a mere device to escape taxation. I think the agreement must be construed as meaning that the Company alienated its interest in that proportion of the production in question, and in the proceeds of such production. If that results in giving an advantage in taxation to the Company over another corporation which secures its working capital by the sale of its capital stock or its securities that would be a matter which concerns the legislature rather than the Courts.

The Income War Tax Act enacts that "for the purposes of this Act, 'income' means the annual net profits or gains . . . directly or indirectly received by a person . . . from any trade, manufacture or business . . ."

Can it be said that the Company received any "net profits or gains" from the percentage of production that was sold to others, the proceeds of which in point of fact it never received? I do not think one can so hold. The production in question may have been under the direction of the Company as operator of the undertaking, on behalf of all those holding royalty interests, but not as owner. The Company could not, I think, successfully assert that the proceeds derived from the sale of the production in question belonged to it, or that it was a profit or gain to which it was entitled. I do not see how it can be said that the net proceeds of production paid to holders of royalty interests was a net profit or gain to the Company, in the period in question. I am unable to satisfy myself that any other conclusion can be reached than that the appeal of the Company should be allowed, and with costs.

I perhaps should add a few words further. The Trust Agreement refers to certain taxes as being deductible items in calculating the net proceeds of production distributable among holders of royalty interests. I think this refers to provincial and municipal taxes, and it was not suggested by counsel for the Minister that this was intended to include the corporation income tax here in question.

*Judgment accordingly.*