BETWEEN:

WILBERT L. FALCONER ..... APPELLANT;

1961

Apr. 12, 13

June 1

AND

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

Revenue—Income tax—Income or capital gain—Valuation of securities received in satisfaction of a debt—No evidence that valuation of Minister wrong—Appeal dismissed.

Appellant was a member of a syndicate formed to develop an oil property. The syndicate sold its working interest in the property to a corporation, receiving escrow stock of the corporation in satisfaction of its liability for the purchase price, the payment being

1961

FALCONER v. MINISTER OF NATIONAL REVENUE

made after the flotation of the company as a public company. The shares received by the appellant for his interest in the syndicate were valued by the respondent at twenty cents per share and their value was added to appellant's income for the taxation year 1951, as being a receipt of an income nature. An appeal from the assessment so made was dismissed by the Income Tax Appeal Board and a further appeal to this Court was taken.

Held: That the appeal must be dismissed.

2. That on the evidence the value of the shares fixed by the respondent at about one-half the price at which shares not subject to escrow were sold to the public had not been shown to be excessive.

APPEAL under the *Income Tax Act.*

The appeal was heard before the Honourable Mr. Justice Thurlow at Calgary.

J. H. Laycraft for appellant.

Michael Bancroft and *C. S. Bergh* for respondent.

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

THURLOW J. now (June 1, 1961) delivered the following judgment:

This is an appeal from a judgment of the Income Tax Appeal Board[1], by which the appellant's appeal from a re-assessment of income tax for the year 1951 was dismissed. In making the re-assessment, the Minister included in the computation of the appellant's income a sum of $66,400 as the value of certain shares of Ponder Oils Limited to which the appellant became entitled in 1951 and which the Minister considered to be a receipt of an income nature. Following notice of objection by the appellant, the Minister undertook to reduce the amount to $33,200 but in other respects confirmed the re-assessment as made, and the appellant then appealed first to the Income Tax Appeal Board and later to this Court. The issue in the present appeal is whether the sum of $33,200 is properly included in computing the appellant's income.

In his reply to the notice of appeal to this Court, the Minister pleaded that, in re-assessing the appellant, he acted on the assumption that the appellant had performed services for one Paul Moseson and that the shares in question were received by the appellant as remuneration for such services.

[1] 23 Tax A.B.C. 114.

This assumption is disproved by the evidence, and it therefore fails as a basis for including the value of the shares in the computation of the appellant's income. The Minister, however, also pleaded in the alternative that the appellant acquired the shares through a venture in the nature of trade and that their value must therefore be brought into the computation of his income. The position taken by the appellant is that, even if the shares were acquired through a venture in the nature of trade, no profit was realized from the transaction in which they were acquired and that, in any event, such profit was less than $33,200.

The appellant is a geological engineer. For two years after he came to Alberta in 1941 he was employed by a company concerned with the development of Athabaska oil sands and for the following five years by Imperial Oil Limited, at first as an exploration geologist and later as assistant superintendent of the Leduc oil field. In 1948 he became operations manager of Pacific Petroleums Limited, and in 1950 assistant general manager of that company. At that time Imperial Oil Limited held many leases in the Leduc oil field and was following a practice of putting together several locations and offering them on terms to persons interested in drilling for oil on them. The contracts made pursuant to such arrangements were known as farmout contracts. Early in 1951 Paul Moseson, a lumberman and the president of an oil well drilling company, who had examined a number of farmout proposals, offered by Imperial, brought a particular one to the attention of the appellant and a Dr. Nauss, the latter a partner in a firm of consulting geologists known as Link and Nauss.

For some time the appellant and Dr. Nauss, for geological reasons which it is unnecessary to relate, were not impressed with the prospects of obtaining oil on the particular locations, but subsequently they conceived a theory which indicated that the locations had sufficient prospects to warrant drilling operations, and a syndicate consisting of Mr. Moseson, Dr. Link, Dr. Nauss, and the appellant took up the farmout contract offered by Imperial.

The contract was taken in the name of Mr. Moseson. By it, Imperial agreed to sell to him a producing oil well known as Imperial Leduc No. 253, together with the well

1961

FALCONER
v.
MINISTER OF
NATIONAL
REVENUE

Thurlow J.

equipment and the mineral and surface rights in connection therewith, for $40,000 and further agreed to sub-let to him the mineral and surface rights in connection with any producing well which he might drill on five additional locations, reserving, however, to Imperial 5,000 barrels of oil from five per cent of the production of each such well. Moseson, on his part, and in fact on behalf of the syndicate, undertook to drill wells on each of the five locations.

As the drilling of these five wells would entail expenses likely to approach half a million dollars, the syndicate, in order to spread the risk, arranged two further contracts, by one of which Central Explorers Limited in effect purchased a one-half interest in Imperial Leduc No. 253 for $30,000 and for a 40 per cent interest in the first and a 50 per cent interest in the other wells to be drilled undertook to contribute half the cost of the drilling operations with the right to withdraw from participating in the expense of drilling and the production of any well. By the other contract, Banff Oil Limited in effect purchased approximately a quarter interest in Imperial Leduc No. 253 for $15,000 and obtained the right to contribute to the extent of about one-quarter to the cost of drilling of each well in succession and to share accordingly in the production of any well so obtained.

The syndicate used $40,000 of the $45,000 so realized to pay for the well known as Imperial Leduc No. 253 and deposited the other $5,000 in a bank account in trust for a company to be incorporated to take over the syndicate's undertaking. The farmout contract was dated May 25, 1951 and that between Mr. Moseson and Central Explorers Limited, May 17, 1951. The contract between Moseson and Banff Oil Limited was not committed to writing until October 2, 1951, but it is clear on the evidence that the agreement was in fact made at or about the same time as the farmout contract itself. It is apparent therefore that, as a result of these proceedings alone, the syndicate had secured for itself without any cash outlay assets consisting of $5,000 in cash and approximately a quarter interest in the well known as Imperial Leduc No. 253 and in the well-drilling undertaking. It was also committed to proceed

with the drilling required by the farmout contract. The explanation given as to how it transpired that the syndicate could realize 50 per cent more than Imperial's price for the one-half and one-quarter interests in the well and contract was that, since they were experienced men, each expert in his own particular phase of the oil business, and were interested on their own behalf in this undertaking, confidence in their management of it was generated to the point where the other participants were eager to have a share in the undertaking. Moreover, the knowledge that they, after examining the prospects, considered the locations to have sufficient merit to warrant drilling rendered it unnecessary for the participants to incur the expense of obtaining expert opinions on their own as to the merits of the locations.

When the members of the syndicate arranged to take the farmout agreement or prior thereto, they had agreed among themselves to have the undertaking carried out by a corporation, and pursuant to this arrangement Ponder Oils Limited was incorporated on June 15, 1951 as a private company with an authorized capital of 1,000,000 no-par-value shares to be issued for not more than $240,000. The directors of the company were Mr. Moseson, a solicitor, and the solicitor's secretary until August 23, when the appellant replaced the solicitor's secretary. In the meantime, the $5,000 trust account had been transferred to the company, and the company received the proceeds of the syndicate's share of the production of Imperial Leduc No. 253. On or about July 27, the company also undertook the drilling of the first well pursuant to the farmout contract, and in the course of the operation called upon Central Explorers Limited and Banff Oil Limited for their respective shares of the drilling costs. The drilling resulted in a producing well being brought in on September 3, whereupon the syndicate's theory as to the geological formation was established as correct for that location and the prospects of their theory being right as to the other locations brightened as well. The market for oil company shares at the time was extremely buoyant and subscriptions for 251,997 shares of Ponder at forty cents

1961

FALCONER v. MINISTER OF NATIONAL REVENUE

Thurlow J.

each were privately obtained in a very short time early in September from 30 to 35 acquaintances of the syndicate members.

The number of shares for which subscriptions were so taken is of some interest, for it was all that would remain of the authorized share capital of the company after allowing for three incorporators' shares and 748,000 shares which the members of the syndicate had at or before the incorporation of the company arranged among themselves to take in exchange for the $5,000, the farmout agreement, and certain other assets to be transferred to the company by Mr. Moseson and by Dr. Link and Dr. Nauss. None of these shares had, however, been formally allotted when on September 12 the company became a public company and its share capital was increased to 4,000,000 no-par-value shares.

Subsequently, by agreement dated September 25, 1951, Moseson transferred the farmout contract and other assets to Ponder in consideration of 748,000 fully paid shares, which at his direction and pursuant to a written agreement between the members of the syndicate were later allotted to them, the appellant's portion being 166,000 shares. In the agreement between Moseson and the company, it was provided that the shares to be issued pursuant to it should be held in escrow by the transfer agent and registrar of the company and should be released only in accordance with the directions of the Registrar under the Securities Act of the Province of Alberta. It was also agreed that the document should be effective as and from June 15, 1951 as if it had been executed and delivered on that date.

According to the appellant, the members of the syndicate had arranged among themselves in May of 1951 that they would take 750,000 of the shares of the company to be incorporated in consideration of the assets to be transferred to it, of which Moseson was to have 250,000 and the other three members, one-third each of the remainder, which they rounded off at 498,000 to give each 166,000 shares. They also knew then that, in order to raise capital to carry out the drilling program which they had undertaken, it would be necessary to have their shares held in escrow at the discretion of the Registrar. The appellant also said that these arrangements were carried out from the time of the company's incorporation, though the agreement is dated later

because Ponder had no one to press on with the documentation of the arrangements until after the beginning of September. He himself entered the employ of Ponder on September 1, 1951 and presently holds the position of President of the company. He also still holds the 166,000 shares so acquired, the same having been released from escrow during 1953.

It may be added that in October, 1951, an isue of 200,000 shares was privately sold at sixty cents a share and in January, 1952 another issue of 300,000 shares was sold publicly at $1.50. Before the sale of the shares in October, however, Mr. Moseson, on behalf of the syndicate, had executed an agreement further restricting the rights attaching to their shares in the event of a dividend or winding up to parity with the number of shares sold to the public or the number of their shares released from escrow, whichever should be greater, and by January the company had brought in at least one more producing well and had acquired another farmout involving eight more locations to be drilled. Ultimately, the drilling of all five of the locations of the original farmout agreement resulted in producing wells.

The Minister's submission in support of the assessment was that the farmout contract was taken in carrying out a scheme for profit making, that in furtherance of that scheme the contract was transferred to Ponder in consideration of shares, but not until September 25, 1951, at which time the appellant realized profit from the enterprise in the form of a right to shares the value of which at that time must accordingly be brought into the computation of the appellant's income.

Counsel for the appellant, while not conceding that the appellant's right to the shares represented profit from a venture in the nature of trade, did not argue the contrary or put his case on the ground that the right to the shares was not so acquired. His submission was that the appellant's right to 166,000 shares arose immediately upon the incorporation of Ponder or at any rate prior to the commencement by it of drilling operations, that if the value of the 166,000 shares must be brought into the computation of his income as having been realized through a venture in the nature of trade the value at that time should be taken and, as it was no greater than that of his interest in the assets

1961

FALCONER v. MINISTER OF NATIONAL REVENUE

Thurlow J.

transferred to Ponder, which was all that Ponder then possessed, and since no one but the four members of the syndicate was interested in Ponder at the time, there could be no profit realized from the transaction. Alternatively, he took the position that the sales of one-half and one-quarter interests respectively in the Imperial farmout contract for $30,000 and $15,000 respectively indicated a value of not more than $20,000 for the shares above what had been paid to Imperial in connection with the farmout contract, and that, accordingly, the profit for the whole syndicate did not exceed $20,000, of which his share at two-ninths was $4,445, rather than $33,200.

The principle so relied on by the appellant is one of the grounds of the judgment of the Privy Council in *Doughty v. Commissioner of Taxes*[1]. There Lord Phillimore said at p. 336:

> The other ground on which the appellant's case may rest is that the transaction which led to the claim for tax was not a sale whereby any profit accrued to the two partners. The case of *Craig (Kilmarnock)*, 1914 S.C. 338, just referred to is an authority for saying that the Crown is not entitled to take a mere bookkeeping entry as conclusive evidence of the existence of a profit. The two partners made no money by the mere process of having their stock in trade valued at a high rate when they transferred to a company consisting of their two selves.
>
> If they overestimated the value of the stock the value of the several shares became less. The capital of the company would be to this extent watered. As already observed, they could not, by overestimating the value of the assets, make them more.

The principle is one of narrow application and, in my opinion, simply means that no profit arises from a mere transaction whereby an owner transfers property to a company in which he alone is interested. On the facts, that does not appear to me to be the situation in the present case. As I view it, the scheme for profit making in which the members of the syndicate were engaged included the taking up of the farmout contract with Imperial, the promotion of a company and sale of its shares to the public, and the realization of gain by the syndicate members by obtaining for their participation in the scheme and for the assets which they would transfer to the company a considerable interest in the company represented by shares of its capital

[1] [1927] A.C. 327

stock. The question to be answered is what was the value of the right to the shares at the time when the syndicate became entitled to them.

Now Ponder Oils Limited came into existence on June 15, 1951, and from its inception or shortly afterwards appears to have obtained possession of the assets and rights of the syndicate and to have discharged the syndicate's obligations under the farmout contract. But it did not pay for the assets immediately, nor does the consideration for them appear to have been agreed upon between the syndicate and the company. Since Ponder was then a private corporation in which no one but the members of the syndicate was beneficially interested, it may be assumed that the syndicate could have dictated as the consideration to be paid by Ponder whatever they wished, whether in terms of money or shares. It might have been a very high consideration or a very low one or a reasonable one in either money or shares, but whatever it might be, to my mind it could at that time be worth no more than the value of what Ponder had. But while the members of the syndicate had in fact agreed among themselves, even before the incorporation of Ponder, to take a particular number of shares as the consideration, on the evidence I can discover nothing prior to the contract of September 25, 1951 from which any obligation of the company to issue such shares or any right of the syndicate or the members to demand them of the company can be held to have arisen. And even adopting the appellant's contentions to the point that the company was between June 15 and September 25 under an enforceable obligation to pay for what it had acquired from the syndicate, I am unable to find on its part any undertaking to pay in shares. If a contract between the company and the syndicate is to be inferred from the circumstances, including the receipt by Ponder of the production from the well, the carrying on by Ponder of the drilling and the collection by Ponder of the contributions of the participants, the inference I would draw is that Ponder took over the contract in circumstances from which a promise to pay would be implied, but to pay a reasonable sum rather than to issue shares, for I see nothing in what the company did from which a promise to issue shares may be inferred. And even if the receipt of $5,000 in cash as part of what was transferred be regarded as inconsistent

1961

FALCONER v. MINISTER OF NATIONAL REVENUE

Thurlow J.

with a contract to pay in money and, therefore, suggestive that the consideration was to be something else and probably shares, there was still no promise by the company to pay in shares to the exclusion of any other kind of payment. In my view, the syndicate's right to be paid by Ponder in shares arose for the first time on September 25, when their right to payment for what Ponder had acquired from them was converted from a right to be paid in some form to a definite right to shares. By this time, however, as a result of the drilling which had been done, the company assets had increased in value, the value of its shares had grown accordingly, and other persons besides the syndicate members had become interested in the company. The shares in the company to which the syndicate then became entitled were undoubtedly worth more than they would have been if the contract to issue shares had been made in June, and they may also have been worth more than any money payment which might have been recoverable by the syndicate in the meantime, but this is, I think, immaterial. The material fact, in my opinion, is that, through carrying out their scheme, the syndicate became entitled to shares on September 25, but not until then, and thereby realized profit from their scheme in the form of a right to shares. September 25, in my opinion, is accordingly the date at which the right to the shares to which the appellant became entitled should be valued. It was not contended by either party that the valuation of the shares should be made at the end of the year.

It remains then to assess the value of the appellant's right to such shares on September 25, 1951. The principles applicable to such an assessment were discussed as follows by Viscount Simon in *Gold Coast Selection Trust Ltd. v. Humphrey*[1] at p. 472:

> In my view, the principle to be applied is the following. In cases such as this, when a trader in the course of his trade receives a new and valuable asset, not being money, as the result of sale or exchange, that asset, for the purpose of computing the annual profits or gains arising or accruing to him from his trade, should be valued as at the end of the accounting period in which it was received, even though it is neither realized nor realizable till later. The fact that it cannot be realized at once may reduce its present value, but that is no reason for treating it, for the purpose of income tax, as though it had no value until it could be realized. If the asset takes the form of fully paid

[1] [1948] A.C. 459.

shares, the valuation will take into account not only the terms of the agreement but a number of other factors, such as prospective yield, marketability, the general outlook for the type of business of the company which has allotted the shares, the result of a contemporary prospectus offering similar shares for subscription, the capital position of the company, and so forth. There may also be an element of value in the fact that the holding of the shares gives control of the company. If the asset is difficult to value but is none the less of a money value, the best valuation possible must be made. Valuation is an art, not an exact science. Mathematical certainty is not demanded, nor indeed is it possible. It is for the commissioners to express in the money value attributed by them to the asset their estimate, and this is a conclusion of fact to be drawn from the evidence before them.

In the present case, as previously mentioned, during the first week of September some 30 to 35 acquaintances of the members of the syndicate had subscribed for 251,997 shares of the company at 40 cents each. And during October an additional 200,000 shares were privately sold at 60 cents each. These shares, however, were not subject to escrow arrangements as were those of the syndicate when they became entitled to them on September 25. A witness called on behalf of the appellant stated that, while escrowed shares could be disposed of subject to the escrow arrangements, they could not be expected to bring the same price as free shares and the discount would be in the order of 50 per cent, depending on the particular features of the escrow arrangements. This would suggest that the Minister's estimate of the value of the appellant's shares at 20 cents is not incorrect. Having regard to the restrictions which the escrow arrangements place upon the marketability of the shares in question, I should have thought that a preferable approach to the estimation of their value at the material time would lie in considering the value of the assets of the company which would be distributable to the appellant on a winding up at that time, but no evidence was offered as to the extent of the increase in value of the company's assets resulting from the success of the drilling of the first well, and after a lengthy consideration of the evidence, I have come to the conclusion that it has not been established that the assets that would have been available for distribution to members of the syndicate on a winding up at that time would not have been equal to 20 cents a share.

1961

FALCONER v. MINISTER OF NATIONAL REVENUE

Thurlow J.

As mentioned earlier, by an agreement dated October 18, 1951 made with the company by Mr. Moseson on behalf of the syndicate in connection with the sale of a further 200,000 shares of the company at 60 cents, all of which were privately subscribed in the latter part of October, 1951, the syndicate agreed that in the event of a winding up of the company or any capital distribution or dividend being made or declared by the company the syndicate should rank or participate only to the extent of the number of their shares released from escrow or the number of treasury shares sold to the public, whichever should be the greater. This, according to the witness, would further depreciate the sale value of the appellant's shares at the time so that the total discount from market price would be in the order of 75 per cent. In my view, however, the shares to which the appellant became entitled on September 25 were not subject to this agreement, which was made later, but even if it had been tentatively arranged earlier between the members of the syndicate, I do not think it could be regarded as binding them or as affecting the value of their shares prior to October 18, 1951. It therefore has no effect on the value of the shares on September 25, 1951. It might well have had an effect on their value at December 31, 1951, which might be regarded as the end of the accounting period, but as previously mentioned neither party sought to have the value of the shares at that date used in computing the appellant's profit from the venture for the year, and in any case the evidence suggests that the shares were increasing in value and does not indicate that the value at the end of the year was less than 20 cents even after taking this agreement into account.

On the whole, therefore, I am of the opinion that the appellant has not shown that the $33,200 or any part of it was erroneously included in the computation of his income for the year in question. His appeal accordingly fails, and it will be dismissed with costs.

Judgment accordingly.