1958
Mar. 26
1959
Feb. 27

BETWEEN:

LEE SHEDDY ..... APPELLANT,

AND

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

Revenue—Income—Income Tax—Sale of oil and gas leases by syndicate for lump sum—Capital or income—Whether profit from sale of leases income from a "business"—The Income Tax Act, R.S.C. 1952, c. 148, ss. 3, 4, 6(c) (j) and 139 (1) (e).

The appellant was a member of a syndicate which by the merger in 1952 of two syndicates formed in 1950, acquired a number of Alberta petroleum and natural gas leases. Prior to the merger the original syndicates had entered into an agreement with a company which provided that the company was to carry out a seismic survey of the lands with an option to drill. If producing wells were brought in certain payments were to be made and all leases were to be assigned to the company. The survey was made and the option dropped. The new syndicate subsequently granted an option to an oil operator which was followed by formal agreements whereby he agreed to drill the lands at his own expense, to pay $200,000 for the first producing well and $25,000 for each other well brought into production plus certain royalties. The syndicate agreed to assign all its leases to him. One well was brought in in 1952 and ten in 1953 and payment made the syndicate as agreed which in turn paid the appellant his proportion of the payments. The Minister added to the latter's declared income for 1952 and 1953, the amounts so received and re-assessed him accordingly. An appeal from the assessment to the Income Tax Appeal Board was dismissed. On an appeal from the Board's decision to this court appellant contended that the syndicate was not an adventure in the nature of a trade and alternatively, if it could be so described, the leases were capital assets acquired for the purpose of development and in fact so developed; that neither the syndicate nor its members were traders in leases and the isolated sale by the syndicate was the sale of a capital asset.

Held: That on the evidence the conclusion is inescapable that there never was a firm and fixed intention on the part of the members of the Syndicate to regard the leases as an investment to retain and develop on its own account.

2. That the Syndicates were formed for the purpose of carrying on business for profit and the acquisition and sale of leases was one of the contemplated modes of carrying on business in the scheme for profit-making and the profits realized were acquired in the operation of such business and are therefore income from a business within the meaning of s. 3(*a*) of the *Income Tax Act,* or at least within the extended meaning of "business" as found in s. 139 (1)(*e*) of the Act.

APPEAL from a decision of the Income Tax Appeal Board.

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

R. L. Fenerty, Q.C. for appellant.

Michael Bancroft and *T. E. Jackson* for respondent.

CAMERON J. now (February 27, 1959) delivered the following judgment:

This is an appeal from a decision of the Income Tax Appeal Board dated May 24, 1957, dismissing the appellant's appeals from re-assessments made upon him for the years 1952 and 1953. The decision of the Board was based on its finding in another matter heard as a test case at the same time, namely, *Kidd v. M. N. R.*[1]. Similarly, in the hearing of this appeal before me, it was agreed that the evidence tendered should apply to a number of other cases and that the decision which I shall now give would apply to all such appeals.

In each of the years in question, the appellant was a member of and the owner of a number of units in the Drumheller Leaseholds Syndicate. In 1952 and 1953, the Minister added to his declared income the amounts received by him from that syndicate, namely, $16,493.83 and $21,318.39, and re-assessed him accordingly. There is no dispute as to the actual amounts so added, it being admitted that if they constituted taxable income in his hands, the re-assessments made in each year are valid.

For the appellant it is contended that they were merely the realization of a capital asset and as such were not taxable. For the Minister it is submitted that the sums were in the nature of income from a business and therefore within ss. 3, 4 and 139(1)(*e*) of *The Income Tax Act;* and that they also fall within the provisions of s. 6(*j*) of the Act as being amounts received which were dependent on production from property as well as within s. 6(*c*) as being income from a syndicate.

Before considering the legal problems involved, I think it advisable to set out in detail the circumstances surrounding the formation of Drumheller Leaseholds Syndicate and the nature of the operations which resulted in the payment of the amounts in question.

[1] 17 Tax A.B.C. 180; 57 D.T.C. 280.

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The main witness on behalf of the appellant was Mr. Russell Kidd. He appears to have taken a leading part in the formation of all the syndicates and in all their operations. In 1950 he was a garage proprietor in Drumheller, Alberta. It appears that he and a number of friends in the area, who met regularly in a restaurant for coffee, had discussions about the discovery of oil and gas in Alberta and eventually came to the conclusion that as citizens of the area they themselves should take a part in the "oil boom" and participate in such benefits as might accrue therefrom. Accordingly, the group decided to take up petroleum and natural gas leases in the area from the provincial Government, if such leases were available. Certain individuals applied for and were granted such leases from the province.

Exhibit 1 is an agreement dated November 10, 1950 between three such individuals (called the "Trustees") who had acquired leases for a twenty-one year period from August, 1950 over 960 acres, or 6 quarter sections—and twelve persons (including the said three Trustees), called the Beneficiaries. By that agreement, it was declared that the Trustees held the leases in trust for the twelve beneficiaries in equal shares and that the parties thereto were to be known as the "Drumheller Leaseholds", the said Russell Kidd to be the secretary thereof.

Exhibit 2 is a similar agreement dated November 23, 1950, and thereby Glen Phillips, who had secured a similar lease for twenty-one years from August 19, 1950, over 640 acres (4 quarter-sections) in the same locality, declared himself as trustee thereof for five named beneficiaries to be known as the "Munson Leaseholds".

Exhibit 3 is an agreement dated April, 1952, and by its provisions the individuals who were then members of the two syndicates above mentioned, agreed to join together in a new syndicate to be called the "Drumheller Leaseholds". The capital of the new syndicate consisted of 1,600 units and clause 3 of the agreement sets out the respective beneficial interests of the individuals therein, 189 units being allotted to the appellant. Bylaws governing the operations of the Syndicate were passed and therein provision was made for the appointment of officers consisting of

a chairman (Mr. Kidd), the secretary-treasurer, and three directors, who together formed "the Management Committee" of the Syndicate.

On April 25, 1952, the new Syndicate gave to one Louis Diamond of Calgary a 15-day option "on the petroleum and natural gas rights" in all its properties (Exhibit 8). If the option were taken up, Diamond was to drill a well to be selected by Phillips—one of the members of the Syndicate—the expense of such well to be paid in the first instance by Diamond. He was entitled to recoup such expense out of production and thereafter "the production is to be split equally between Diamond and the Syndicate". Then, following the completion of the well, "the rest of the acreage is to be split equally between the Syndicate and Diamond". Provision was made for a more formal agreement if the option were exercised.

Diamond exercised the option and on June 17, 1952 (Exhibit 9), a formal agreement was signed and by its terms Diamond agreed to drill a test well. All the leases held by the Syndicate were to be deposited with a trust company, together with assignments thereof as to 5 quarter-sections (800 acres) to Diamond, who, upon registration thereof, was to be the absolute owner of all the Syndicate's rights therein, provided proof was given that the test well had been drilled to contract depth. As provided in the option, Diamond had the right to recover his drilling costs out of production and thereafter the proceeds from production from the test well were to be divided equally between the Syndicate and Diamond. The general result of the agreement was that Diamond and the Syndicate had equal and joint rights in two legal subdivisions (40 acres each), Diamond and the Syndicate each owning separately 5 quarter-sections less one legal subdivision.

Diamond wanted further rights in the properties retained by the Syndicate and by a further agreement of the same date (Exhibit 10) it was provided that if the Syndicate, after the drilling of the test well, should receive any offer for the acquisition of any rights therein, Diamond should have an option to take up such offer according to its terms. Trident Drilling Co. Ltd. made such an offer on October 20, 1952 (Exhibit 12). Diamond decided to exercise his rights under the second agreement of June 17, 1952, and to enter

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into the same agreement as had been offered by Trident. Accordingly, Exhibit 11 (an agreement dated November 4, 1952) was entered into with the Syndicate. By its terms, Diamond agreed to drill a well, or wells, on the Syndicate's property and to pay $200,000 in cash for the first producing well and $25,000 each for all other wells brought under production. In addition, the Syndicate was to receive a gross royalty of 12½ per cent. of all production of leased substances. In the result, eleven legal subdivisions were drilled out on the properties and the Syndicate received $200,000 for the first well in 1952 and $250,000 for the remaining ten producing wells in 1953. The appellant in 1952 and 1953 received from the Syndicate his proportion of these payments and it is the nature of these receipts which is now in question. Certain royalties were also received but these were included in the appellant's tax returns and therefore no question arises in regard thereto.

One other transaction should be noted. Prior to the formation of the new Drumheller Leaseholds Syndicate, the members of the former syndicates—the Munson group and the Drumheller group—entered into an agreement on June 30, 1951 (Exhibit 5) with Great Plains Development Co. of Canada, Ltd., by the terms of which the latter was within ninety days to commence a seismic survey of the lands and was to have the option of drilling wells thereon. If producing wells were found, Great Plains out of production would recover its costs and the balance of production would be divided equally between it and the members of the syndicate. In addition, if crude oil were discovered in the first well, each member of both syndicates would receive $1,000, or a total of $14,000. It was a term of the said agreement that *all* the leases held by the Syndicate and covering 1,600 acres should be assigned outright to Great Plains. The seismic survey was duly carried out and in the result Great Plains on February 14, 1952, notified the Syndicate that it did not choose to exercise its option to drill wells (Exhibit 6). That letter also stated that Great Plains would take steps "to re-assign the Drumheller Syndicate leases to the persons as provided for in the agreement". It was following that notice that the Syndicate gave to Diamond the option of April 25, 1952 (Exhibit 8).

It is abundantly clear from the evidence as a whole that from the formation of the two original syndicates onwards, the members of the Syndicate were in business. Officers and a management committee were appointed; many meetings were held and the minutes duly recorded; legal transactions were entered into, properties were acquired and options granted. Admittedly, they were in business for the purpose of making a profit. It is urged, however, that from the inception, the intention was to acquire the oil leases and to hold them for the benefit of the members by exploring, drilling wells, and operating them, on their own account; that there was no intention to trade in leases. Now there is some oral evidence to support this view and there is also evidence of letters written on behalf of the Syndicate indicating that it was not anxious to part with the leases by sale. Apparently, it hoped to enter into an agreement with a well driller who would undertake to drill wells at his own expense, take a share of production in compensation and permit the Syndicate to retain ownership of the leases. In this it was totally unsuccessful.

Now it must be kept in mind that the members of the Syndicate had no experience in exploration or drilling for oil or in the operation of oil wells. They were amateurs in this field and possessed of relatively little capital. It is said that the cost of drilling the first successful well which came into production in September 1952, was $112,000. In any event, the members of the Syndicate did not at any time take any steps on their own behalf to acquire any equipment for drilling purposes, or anything of that sort. All that they contributed was a small amount necessary to pay the annual fee of one dollar per acre to the provincial government, nothing being contributed for the purpose of drilling. The unlikelihood of the Syndicate ever drilling a well on its own account was expressed very clearly by Kidd, who, when asked if the Syndicate had ever considered drilling a well, said, "We talked if it come to the worst we would drill a well because we had, a few of us had a few dollars, we have businesses and farms".

On the whole of the evidence, I am satisfied that the leases were acquired with the intention of turning them to account for the benefit of the members in the best manner possible. There is nothing in any of the Syndicate's agree-

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ments which evidenced the intention of the members to hold and operate the leases themselves, and while they may have considered that the most desirable method, it is obvious they were willing to consider other methods, including the disposal of the leases themselves. The original syndicates were formed in November 1950, and the minutes of all syndicate meetings are found in Exhibit 4. The first meeting of the Drumheller Leaseholds was held on December 19, 1950, and the minutes show that the members authorized the officers and directors "to consider any deals and carry out correspondence with all interested parties in connection with our holdings". The next meeting of the two original syndicates was held on April 18, 1951, and authorization was then given to enter into the agreement with Great Plains Development Co., the terms of which had been apparently negotiated in the meantime. That agreement, it will be recalled, provides for the assignment to Great Plains of all the leases outright and apparently that was done.

A consideration of the whole of the evidence and particularly that relating to the Great Plains option, the Trident offer which the Syndicate was prepared to accept if Diamond had not exercised his prior rights in regard thereto, and the several contracts entered into with Diamond, leads me to the conclusion that almost from the time the leases were acquired, the Syndicate was prepared to dispose of some or all of the leases by sale. All were assigned to Great Plains, but were later re-assigned. In the final result, it did dispose of 8 quarter-sections in that manner, retaining only two on which it has expended nothing for development.

The relevant sections of *The Income Tax Act* applicable on this point are as follows:

3. The income of a taxpayer for a taxation year for the purposes of this Part is his income for the year from all sources inside or outside Canada and, without restricting the generality of the foregoing, includes income for the year from all

(*a*) businesses,

(*b*) property, and

(*c*) offices and employments.

4. Subject to the other provisions of this Part, income for a taxation year from a business or property is the profit therefrom for the year.

* * *

139.(1) In this Act,

(*e*) "business" includes a profession, calling, trade manufacture or undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade but does not include an office or employment.

As stated in *Minerals Ltd. v. M. N. R.*[1]—a decision of the Supreme Court of Canada—the test to be applied in resolving the issue as to whether such receipts represent taxable income or a capital increment, is the frequently cited statement of the Lord Justice Clerk in *Californian Copper Syndicate v. Harris*[2].

It is quite a well settled principle in dealing with questions of assessment of Income Tax, that where the owner of an ordinary investment chooses to realize it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit in the sense of Schedule D of the *Income Tax Act* of 1842 assessable to Income Tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable, where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business. The simplest case is that of a person or association of persons buying and selling lands or securities speculatively, in order to make gain, dealing in such investments as a business, and therefore seeking to make profits. There are many companies which in their very inception are formed for such a purpose, and in these cases it is not doubtful that, where they make a gain by a realisation, the gain they make is liable to be assessed for Income Tax.

What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being—Is the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?

In *Sutton Lumber and Trading Co. Ltd. v. M. N. R.*[3], Locke J., in delivering the judgment of the Court, said:

The question to be decided is not as to what business or trade the company might have carried on under its memorandum, but rather what was in truth the business it did engage in. To determine this, it is necessary to examine the facts with care.

The same point was emphasized by the learned President of this Court in *M. N. R. v. Taylor*[4], where he stated:

The considerations prompting the transaction may be of such a business nature as to invest it with the character of an adventure in the nature of trade even without any intention of making a profit on the sale of the purchased commodity. And the taxpayer's declaration that he entered upon the transaction without any intention of making a profit on the sale of the purchased property should be scrutinized with care.

[1] [1958] C.T.C. 236.
[2] [1904] 5 T.C. 159 at 165.
[3] [1953] 2 S.C.R. 77 at 83.
[4] [1956] C.T.C. 189 at 212.

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It is what he did that must be considered and his declaration that he did not intend to make a profit may be overborne by other considerations of a business or trading nature motivating the transaction.

In this case, when one considers the evidence as a whole, particularly what the Syndicate actually did with its leases, the conclusion is inescapable that there never was a firm and fixed intention on the part of the members of the Syndicate to regard these assets as an investment which the Syndicate would retain and develop on its own account. They may have hoped to do so, but were prepared very shortly after the acquisition of the leases, and at the first joint meeting of the two syndicates, to dispose of them in their entirety as evidence by the Great Plains agreement, as well as by the later ones. The sales made were entirely voluntary, were carried out in a business manner and in accordance with the normal practice of those engaged in the buying and selling of leases.

I find, therefore, that the Syndicates were formed for the purpose of carrying on a business for profit; that the acquisition of leases and the sale thereof was one of the contemplated modes of carrying on its business in its scheme for profit-making and that the profits realized and now in question were acquired in the operation of such business. Such profits are, therefore, income from a business within the meaning of s. 3(*a*) of the Act, or at least within the extended meaning of "business" as found in s. 139(1)(*e*).

In view of this finding, it becomes unnecessary to consider whether, as contended on behalf of the Minister, the receipts also fall within s-ss. (*c*) and (*j*) of s. 6.

The appeals for both years will therefore be dismissed and the re-assessments made upon the appellant affirmed. The respondent is entitled to his costs after taxation.

Judgment accordingly.