BETWEEN:

JOHNSTON TESTERS LTD. .....APPELLANT;

1965
Jan. 25-27
Feb. 26

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

Revenue—Income—Income tax—Deductibility of expense payment made for purpose of gaining or producing income—Commutation of future annual royalty payments under patent licensing agreement—Income or

[1] [1923] 4 D.L.R. at 1117.

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capital disbursement—Pro tanto going out of business—Benefit from payment of a revenue character—Income Tax Act, R.S.C. 1952, c. 148, ss. 11 and 12(1)(a) and (b).

This is an appeal in respect of an income tax assessment for the taxation year 1958 whereby a tax was levied on a commutation payment made by the appellant to obtain the release of an obligation to pay certain royalties on patents which obligation would otherwise have continued on an annual basis until 1972.

The two patents in question were U S A. patents for a main valve testing tool and a hydraulic valve tool, both of which devices were used in carrying out certain tests in the discovery and development of oil wells. The main valve testing tool patent was issued in the early 1930's to one M. O. Johnston and the hydraulic valve tool patent was issued to Johnston Testers Inc, a U S. company of which the appellant was a wholly owned subsidiary at all material times. The main valve testing tool patent owned by M. O. Johnston was assigned in part to other members of his family and the several owners licensed the appellant and the other Johnston companies, including Johnston Testers Inc., in 1951 to use it on a royalty basis This agreement was amended several times to extend the terms providing for royalty payments.

In 1956, Schlumberger Well Surveying Corporation purchased all the assets of Johnston Testers Inc, including all the outstanding shares of the appellant, and at the same time the appellant and Johnston Testers Inc. entered into a licensing agreement with the Johnston family under which they were licensed to use both the main valve testing tool and the hydraulic valve tool on a royalty basis, the terminal date for royalty payments being December 1, 1972. The evidence established that the purchase of the appellant and Johnston Testers Inc. by Schlumberger Well Surveying Corporation would not have been completed had the licensing agreement with respect to both devices not been entered into. This was an arm's length transaction between the parties thereto.

The appellant paid its share of the royalties under the licensing agreement from January 31, 1956, the date of the agreement, until 1958, and its payments were allowed as expenses chargeable against income in 1956 and 1957. In 1958 the appellant and Johnston Testers Inc. contracted to commute the remaining royalty payments under the agreement and the appellant's share of the commutation payment was $146,850.18 (Can.).

Because of income tax considerations, the Johnston family sold their interest in the two patents to the Schlumberger Foundation, a charitable organization, for $950,000, and that Foundation granted a release of the royalty agreements to the appellant and the other Johnston companies for $1,000,000. The foundation was free from any control by Schlumberger Well Surveying Corporation or any of its associated or subsidiary companies and of any of the Johnston companies at all material times.

Held: That it is clear beyond doubt that the commutation payment was made for the purpose of gaining a producing income within the meaning of s. 12(1)(*a*) of the *Income Tax Act* using as a criterion for such conclusion that it was made based on good commercial practice, and bearing in mind that it did not have to be incurred in gaining or producing the income of the particular period in which it was expended and that no casual connection had to be established between any

particular receipt of income and this expenditure, and that it was an extraneous and non-recurring item of expenditure.

2. That in the final analysis, no one criterion adopted in the decided cases can be universally used in all cases to determine whether the payment is a capital expenditure or one chargeable against income. The business purpose of a commutation payment in each case must be analyzed carefully for the object of categorization and then one or more of the various criteria may be employed to assist in determining the correct category of such payment.

3. That by the 1956 licensing agreement the appellant acquired a capital asset, viz., the licence to use the two patents.

4. That the payment under consideration was a payment made to get rid of an annual charge against revenue in the future and was not made to get rid of a loss or apprehended loss in business after the income and expenditure had been put together, as was the case in all the instances where there was a *pro tanto* going out of business. This payment was not made in order to *pro tanto* go out of business but was made in the course of and for the purpose of a continuing business, and the appellant did in fact after this payment and still does carry on the same business.

5. That on the particular facts of this case the true business purpose of the commutation payment by the appellant, in essence, was not to get rid of a capital asset (which was a mere incidental result) but instead to get rid of an onerous annual expense in respect to a business that it proposed to and did carry on, and such payment was made in the course of such continuing business. As a result no advantage or benefit either positive or negative accrued to the capital account of the appellant, but instead all the advantage and benefit obtained was of a revenue character and, therefore, the payment was not a capital outlay within the meaning of s. 12(1)(*b*) of the *Income Tax Act*.

6. That the appeal is allowed.

APPEAL from a decision of the Tax Appeal Board.

The appeal was heard by the Honourable Mr. Justice Gibson at Toronto.

H. H. Stikeman, Q.C. and *P. N. Thorsteinsson* for appellant.

Donald J. Wright and *D. G. H. Bowman* for respondent.

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

GIBSON J. now (February 26, 1965) delivered the following judgment:

This is an appeal from the decision of the Tax Appeal Board dated October 28, 1963, in respect of the income tax assessment of the appellant dated December 9, 1959, for the taxation year 1958 whereby a tax in the sum of

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$67,418.10 plus interest in the sum of $2,792.77 was levied for the said taxation year.

The monies which are the subject matter of this appeal were a commutation payment made by the appellant in the taxation year 1958 in the sum of $150,000 (U.S.) or $146,850.18 (Can.). The purpose of such commutation payment was to obtain the release of an obligation to pay certain royalties on patents which obligation otherwise would have continued on an annual basis until the year 1972.

The annual royalty payments which had been made annually up to the taxation year 1958 by the appellant approximated $20,000 per year, and the appellant charged against income the said whole payment of $146,850.18 (Can.) made in the 1958 taxation year.

The Tax Appeal Board disallowed in part this expense, allowing as a charge against income only the accrued royalties up to January 31, 1958, which was the date of the release agreement under the terms of which the said commutation payment was made by the appellant. This allowance amounted to $5,872.22 (Can.). The balance of $140,997.96 the Tax Appeal Board found was an outlay of capital or a payment on account of capital the deduction of which in computing the appellant's income for the 1958 taxation year was prohibited by reason of paragraph (*b*) of subsection (1) of section 12 of *The Income Tax Act*.

The appellant at the material time was a wholly owned subsidiary of a United States company known as Johnston Testers Inc., of Houston, Texas, and it carried on in Canada the business of performing certain oil well tests for others and earned its income by charging such other persons, who were owners of oil wells, fees for its testing service. This service provided is called a drill stem test which the evidence discloses is a procedure whereby a sample of the hydrocarbons or other fluids from the bottom of an oil well that is in the process of being drilled are trapped in a device fixed to the end of the drilling shaft or stem and then are brought to the surface for examination and evaluation. The device in which the fluids are trapped is called a testing tool.

The drill testing tools which we are concerned about on this appeal are called firstly a main valve testing tool for

which U. S. patent No. 2,126,641 was issued to one M. O. Johnston and a hydraulic valve tool for which U.S. patent No. 2,703,696 was issued to Johnston Testers Inc., of Houston, Texas. A copy of each of these patents was filed as Exhibits 1 and 2 on this appeal.

The main valve testing tool devised by the inventor M. O. Johnston in the early 1930's, in part was assigned by him to certain members of his family and then on June 1, 1951, M. O. Jonhston and his family entered into a written contract with the appellant and the other Johnston companies including Johnston Testers Inc., whereby the latter were given the exclusive right to use the patent on this main valve tool on a royalty basis. This agreement was filed as Exhibit 3 on this appeal.

This 1951 royalty agreement was subsequently amended several times by agreements dated December 2, 1953, January 31, 1955, and August, 1955, which agreements purported to extend the terms under which the licensees would be required to pay royalty payments to the licensors. The purported reason given for these various amended agreements was that in each instance there had been an improvement to the basic patent and for each of such improvements a patent application had been made by the licensors. There was a dispute as to the precise meaning of these extension agreements in so far as the same concerned the question of whether these amending agreements in fact extended the term during which the appellant and the others were obligated to make royalty payments to the Johnston family.

In my view, however, this is not of any great significance because the important agreement in so far as this appeal is concerned is the agreement dated January 31, 1956. This agreement was entered into contemporaneously with the purchase agreement whereby a firm known as Schlumberger Well Surveying Corporation purchased all the assets of Johnston Testers Inc., of Houston, Texas, which assets included all the outstanding shares of the appellant company.

The said hydraulic valve tool patent which we are concerned with on this appeal was not licensed in the abovementioned 1951 licensing agreement with the Johnston

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family nor was it included in any of the amending agreements to the 1951 agreement, but it was, however, included in the said agreement dated January 31, 1956.

The hydraulic valve tool, embodying the principle of the said patent for it, had in substantial measure replaced the main valve tool because it was a superior instrument and at the material time in 1956 the appellant and the other Johnston companies were in the main using the hydraulic valve tool in providing their services to their customers to earn their respective incomes. However, the main valve tool was not entirely supplanted until a year or two after the actual purchase as of the 31st of January, 1956, by Schlumberger Well Surveying Corporation.

The evidence discloses that Schlumberger Well Surveying Corporation as early as 1955 entered into negotations for the purchase of the assets of Johnston Testers Inc., of Houston, Texas, but this early date is of no significance, and this purchase was completed as of January 31, 1956.

The relevant contract documents evidencing this transaction were filed on this appeal as Exhibits 8 and 14. In so far as this appeal is concerned, however, Exhibit 14 which is the contract amending the royalty agreement is a significant agreement. This is the January 31, 1956, licensing agreement above referred to.

By this 1956 contract the appellant and Johnston Testers Inc., of Houston, Texas, agreed to pay royalties to the Johnston family on both the main valve tool and the hydraulic tool notwithstanding the fact that by contract up to that time neither the appellant nor Johnston Testers Inc. were liable to pay royalties to the Johnston family for the use of the hydraulic tool patent. The hydraulic tool patent in fact was owned by Johnston Testers Inc. The appellant had no title to it at any time. The agreement also provided that there would be a terminal date for such obligation to pay royalties and it was fixed at December 1, 1972. The latter provision was the significant one in so far as this action is concerned.

There were many documents filed and much argument submitted for the purpose of demonstrating the reason the appellant and Johnston Testers Inc. entered into this 1956 royalty agreement with the Johnston family. Without detailing all this evidence nor referring to the submissions

made, it is sufficient for the purposes of this appeal to state that in my opinion the purchase contract between Schlumberger Well Surveying Corporation and Johnston Testers Inc. by which the former acquired the shares of the appellant company would not have been completed if this licensing agreement of 1956 had not been consummated.

And I am unable to find on the evidence that the substance of this 1956 royalty agreement is anything different than the document purports to state.

I, therefore, find that this agreement was a legal and binding contract made at arm's length between the appellant and Johnston Testers Inc. as licensees and the Johnston family as licensors to pay an annual royalty on both the main valve tool and the hydraulic valve tool until December 31, 1972.

In respect to this contract, the evidence was that after January 31, 1956, and until 1958, the appellant and Johnston Testers Inc. did pay the Johnston family royalties on these patents. The payees and payers were strangers in law and the royalties paid were allowed as an expense chargeable against the income of the appellant for the years 1956 and 1957. In 1956 such payment by the appellant amounted to $19,433.95 and in 1957 it amounted to $19,459.18. And the royalty payments from 1953 under the respective current agreement had consistently been about $19,000 or $20,000.

In 1958 the appellant and Johnston Testers Inc. entered into negotiations and did by contract commute these royalty payments. The commutation payment made by the appellant was in the sum of $150,000 (U.S.) or $146,850.18 (Can.) and by Johnston Testers Inc., $850,000 (U.S.).

At first the negotiations for the release of these royalty obligations with the Johnston family had been unsuccessful. The apparent reason for this was because the proposal first made to the Johnston family would have resulted in the payment to them being categorized as income in their hands. This was unacceptable to them because of the income tax disadvantage, and so instead different arrangements were made which caused the monies received by the Johnston family to be categorized as a capital receipt in their hands.

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The Johnston family sold all their right, title and interest in these two patents (of which they only had title to one, *viz.*, the main valve patent—any claim to the hydraulic valve patent being questionable) to a charitable organization known as Schlumberger Foundation for $950,000; and then the Schlumberger Foundation granted the release of the royalty agreements to the Johnston companies, including the appellant, for $1,000,000 and thereby the Foundation itself made a profit of $50,000.

The Schlumberger Foundation being an exempt taxpayer under United States tax laws as a charitable organization kept the $50,000 profit for its organization. (In connection with this transaction, it should be noted that the evidence disclosed that the Schlumberger Foundation at the material time was free of any control by the Schlumberger Well Surveying Corporation or any of its associate or subsidiary companies and also of the appellant or any of the other Johnston companies.)

It was argued firstly that the 1956 patent royalty agreement with the Johnston family was really part of the purchase price of the assets of Johnston Testers Inc. by Schlumberger Well Surveying Corporation, but I am unable on the evidence to find that this was so.

It was next argued that there was no necessity for the appellant to covenant in this 1956 agreement to pay any royalties in respect to the hydraulic valve tool patents because the latter in law were at that time owned by Johnston Testers Inc. In this connection there was some equivocation in the evidence of Mr. Cox, the Texas attorney of Schlumberger Well Surveying Corporation as to the reason why it was agreed to pay royalties in this 1956 agreement on the hydraulic valve tool to the Johnston family and he did not conclusively explain why this 1956 patent royalty agreement called for an undifferentiated payment of royalties, in that there was a bulk royalty payment called for, and no division was made in such payment as between the main valve tool and the hydraulic valve tool. But in so far as the appellant is concerned, this is really of no legal concern because as stated it at no time had any title to the patent for this tool, and the royalty it was called upon to pay by this 1956 agreement was reasonable according to the evidence.

The documents evidencing these transactions were filed on this appeal and in essence they demonstrate that these transactions were all made at arm's length and they establish that the Schlumberger Foundation contracted contemporaneously with the Johnston family to pay them $950,000 for the assignment of their patent rights and with the appellant and Johnston Testers Inc. obligating them to pay it $1,000,000 for a release from the royalty agreement of 1956 in respect to these said two patents. In other words, the Schlumberger Foundation at the material time was not obligated to complete the contract with the Johnston family unless the appellant and Johnston Testers Inc. completed their contract with it for the release of the royalty agreements.

The issue on this appeal, therefore, is whether or not the appellant in these circumstances can charge as an expense against its income for the year 1958 the sum of $140,977.96 (being $146,850.18 less the sum of $5,872.22 paid in respect of royalty payments accruing to January 31, 1958).

In considering this, it should be observed that the Tax Appeal Board made one main assumption, namely, that the Schlumberger Foundation acted as agent for the Schlumberger Well Surveying Corporation, the owner of Johnston Testers Inc. and the appellant, in arranging the release agreement dated January 31, 1958, and that "the Schlumberger Well Surveying Corporation, in effect, purchased the patents in question as a capital transaction for the purpose of terminating the liability of its nominee, Johnston Testers Inc., and in turn, that of its subsidiary, Johnston Testers Ltd., the appellant herein, in respect of the royalty payments payable until December 31, 1972, under Exclusive Licensing Agreement dated 1st June, 1951."

I must respectfully disagree with this assumption and, therefore, also the opinion of the Board predicated on it. Instead, I am of the opinion that Schlumberger Foundation in this particular series of transactions was a stranger in law with the parties with whom it dealt and that no relationship of agency existed in respect to any of the transactions between it and the appellant through any of the corporate convolutions which took place in completing the same.

This finding, however, does not resolve the matter.

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The problem here is to determine on the facts of this case whether or not this commutation payment of $140,977.96 (Can.) was a trading or income disbursement or a capital disbursement of the appellant for the income tax year 1958 on a true application of the relevant jurisprudence.

In all cases where commutation payments are made, the application of the distinction between income disbursements and capital disbursements is difficult because such payments lie on the borderline, and the problem of assigning them to income or capital is always troublesome.

The Income Tax Act, R.S.C. 1952, does not define "income" nor "capital". It describes sources of income and prescribes methods of computing income. It is, therefore, necessary to find the answer in a given factual situation by reference to the decided cases; and the answer in these cases is to a question of mixed fact and law.

Counsel for the appellant referred to, mentioned or distinguished the following cases in support of their submission that the commutation payment in this case was an income disbursement: *Royal Trust Co. v. M. N. R.*[1]; *Anglo Persian Oil v. Dale*[2]; *Noble v. Mitchell*[3]; *Mallett v. Staveley Coal and Iron Company Limited*[4]; *Dain v. Auto Speedways Ltd.*[5]; *C.I.R. v. William Sharp & Son*[6]; *Bedford Overseas Freighters Ltd. v. M. N. R.*[7]; *B. C. Electric Railway Company Limited v. M. N. R.*[8]; *Falaise Steamship Company Limited v. M.N.R.*[9]; *Halifax Overseas Freighters Ltd. v. M.N.R.*[10]; *Stow Bardolf Gravel Co. v. Poole*[11]; *Knight v. Calder Grove Estates*[12]; *J. P. Hancock v. General Reversionary & Investment Co. Ltd.*[13]; *Shove v. Dura Manufacturing Co. Ltd.*[14]; *Green v. Cravens Railway Carriage & Wagon Co. Ltd.*[15]; *I.R.C. v. British Salmson Aero Engineers Ltd.*[16]; *Cowcher v. Richard Mills & Co. Ltd.*[17]; *West African Drug Co. v. Lilley*[18].

Counsel for the respondent on the other hand in a similar manner referred to the following cases to support his sub-

[1] [1957] C.T.C. 32.
[2] 16 T.C. 253.
[3] 11 T.C. 372.
[4] 13 T.C. 772.
[5] 38 T.C. 525
[6] 38 T.C. 21
[7] [1959] C.T.C. 58.
[8] [1957] Ex. C.R. 1.
[9] [1959] C.T.C. 67.
[10] [1959] C.T.C. 71.
[11] 35 T.C. 459.
[12] 35 T.C. 447.
[13] 7 T C. 358.
[14] 23 T.C. 779.
[15] 32 T.C. 359.
[16] 22 T C. 29.
[17] 13 T.C. 216.
[18] 28 T.C. 140.

mission that the disbursement in this case was one of capital:

Peters v. Smith[1]; *James Snook v. Blasdale*[2]; *Royal Insurance v. Watson*[3]; *Pyrah v. Annis*[4]; *Associated Portland Cement*[5]; *Glenboig v. C.I.R.*[6]; *Dominion Natural Gas*[7]; *British Insulated*[8]; *Cowcher v. Richard Mills*[9]; *Mallet v. Stavely*[10]; *VandenBerghs v. Clark*[11]; *West African Drug v. Lilley*[12]; *B. C. Electric Railway v. M. N. R.*[13]; *C.I.R. v. Sharp*[14]; *Dain v. Auto Speedways*[15]; *DeSoutter v. Hanger*[16]; *Constantinesco v. R.*[17]; *Anglo Persian v. Dale*[18]; *Eagle Motors*[19].

In coming to a conclusion in this case, two questions have to be resolved, namely, (1) was the expenditure of $140,977.96 by the appellant in the taxation year 1958 made for the purpose of gaining or producing income within the meaning of section 12(1)(*a*) of *The Income Tax Act*? and (2) if it was so made, was such payment an allowable expense or was it a capital outlay within the meaning of section 12(1)(*b*) of *The Income Tax Act*?

In this case it is clear beyond all doubt that the expenditure was made "for the purpose of gaining or producing income" within the meaning of section 12(1) (*a*) of *The Income Tax Act,* using as a criterion for such conclusion that it was made based on good commercial practice, and bearing in mind that it did not have to be incurred in gaining or producing the income of the particular period in which it was expended and that no causal connection had to be established between any particular receipt of income and this expenditure, and that it was an extraneous and non-recurring item of expenditure. And it should be noted that all this is true whether this expenditure be classified as an income expense or disbursement, or as a capital outlay or disbursement.

[1] (1963) 41 T.C. 264.
[2] 33 T.C. 244
[3] [1897] A.C. 1.
[4] (1957) 1 All E.R. 196 affirming [1956] 2 All E.R. 858.
[5] [1947] 1 All E.R. 68.
[6] 12 T.C. 427.
[7] [1941] S.C.R. 19.
[8] [1926] A.C. 205.
[9] (1927) 13 T.C. 216.
[10] 13 T.C. 772.
[11] [1935] A.C. 431.
[12] (1947) 28 T C. 140.
[13] [1958] C.T.C. 21.
[14] (1959) 38 T.C. 341.
[15] (1959) 38 T.C. 525.
[16] [1936] 1 All E.R. 535.
[17] (1927) 11 T.C. 730.
[18] [1932] 1 K B. 124.
[19] 64 D.T.C. 829.

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In determining the second question of whether this expenditure is an income disbursement or a capital disbursement various tests or criteria are employed in the cases, as are hereinafter referred to. But probably no such determination would have had to be made in this case except for the fact that the amount sought to be charged against income is very large, and except for the fact that there is no provision for amortizing commutation payment expenditures such as this, in any category under section 11 of *The Income Tax Act,* or any regulation made thereunder. However, neither comment is relevant in assisting in the solution of the problem here.

In many cases, Judges have used various criteria which have assisted them in deciding this issue, based on the respective facts of such cases. For example, the criterion afforded by the economists and used by some Judges in the solution of this issue is their differentiation between fixed and circulating capital. If the payment can be categorized as out of the former, the economists say it is a capital expenditure and if out of the latter it is an income expenditure.

The criterion of the accountants, which has been sometimes used in these cases, is their test as to whether such expenditure, in good and accepted commercial accounting practice, should be recorded in the books as a charge in the profit and loss account rather than a payment out of capital account.

Neither of these two above criteria, however, are of much assistance in determining the problem here.

The criterion distinguishing between a "once and for all" lump-sum payment made in the income account as opposed to the capital account by the House of Lords in the case of *Atherton v. British Insulated Cables Ltd.*[1] was put this way by Lord Cave at p. 192, "But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital."

[1] 10 T.C. 155.

But Mr. Justice Rowlatt in *Anglo-Persian Oil Co. Ltd. v. Dale (supra)*, considered that this finding was inconclusive, and that there was fallacy in the use of the word "enduring", and stated that "What Lord Cave is quite clearly speaking of is a benefit which endures, in the way that fixed capital endures, not a benefit which endures in the sense that for a good number of years it relieves you of a revenue payment." And then he held that the commutation payment made in the case before him represented the future emoluments (of the agent) which were redeemed and that it was made in the course and for the purposes of a continuing business.

Some other criteria adopted in the cases are that if the commutation payment either (a) creates a capital asset of enduring or permanent character as, e.g., plant machinery, etc.; or (b) if it is a payment in respect of a capital asset in order to *pro tanto* go out of business, it will be categorized as a capital expenditure, but if, (c), the commutation payment does not create a capital asset even though it is made in respect to a capital asset and the business or that part of it continues after such payment, and such payment was made for the purpose of such continuing business, then the payment will be categorized as an income expenditure.

In the final analysis, however, it would appear that no one criterion can be used universally in all cases. Instead, the business purpose of a commutation payment in each case must be analyzed carefully for the object of categorization and then one or more of the various criteria may be employed to assist in determining the correct category of such payment, that is, whether the payment truly is an income disbursement or one out of capital account.

In this case by the said 1956 agreement the appellant I find acquired a capital asset, *viz.*, the license to use the two patents.

Such asset could have been shown on the balance sheet of the appellant as a capital asset, in which event its value would have been recorded as nominal. Its ommission from the balance sheet in this case, however, was commercially acceptable accounting practice in that such omission did not affect the integrity of the balance sheet. And when it ceased to be a capital asset of the appellant in 1956, such

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fact did not in any significant way affect the capital account of the appellant.

The acquisition of this capital asset gave the appellant the right to use the patents, as distinguished from the use or employment of the machines embodying such patents, which latter was the business carried on by the appellant by which it earned its income.

In respect to the latter only, the appellant paid the licensors of the patents annual royalties, calculated on actual use. For the former there was no actual dollar consideration paid.

The said release agreement in 1958 accomplished two things, namely, it got rid of the said capital asset, but the appellant paid no dollar consideration for this; and it got rid of the onerous annual payments of royalties to these licensors for use of the patents until 1972.

In other words this latter was a payment to get rid of an annual charge against revenue in the future. It was not made to get rid of a loss in business or apprehended loss in business after the income and expenditure had been put together, as was the case in all the instances when there was a *pro tanto* going out of business. On the contrary, the money paid in this case was not paid in order to *pro tanto* go out of business. The money was paid in the course of and for the purpose of a continuing business, and the appellant did in fact after this payment and still does carry on this same business.

It was argued that the appellant did *pro tanto* go out of business in so far as its use of the main stem valve tool was concerned because it no longer could use this machine after this release agreement was executed. And it was a fact that at that time the appellant had stopped using the main valve tool because it had been supplanted by the superior hydraulic valve tool.

But the appellant was entitled after this release agreement in 1958 to continue the use of this hydraulic valve tool by arrangements with Johnston Testers Inc. who in fact owned the patent to it, and the appellant did continue in precisely the same business as it had been in before. What it got rid of by this commutation payment in 1958 in exchange for the release agreement was the large annual royalty charge against its revenue, payable to the Johnston

family under the said 1956 agreement. And, therefore, I am unable to find that by ceasing to use the main valve testing tool in 1958 the appellant could be considered to be *pro tanto* going out of any part of its business.

In brief, therefore, I find that the true business purpose of this commutation payment of $140,977.96 (Can.) in 1958 by the appellant, in essence, was not to get rid of a capital asset (which was a mere incidental result), but instead it was to get rid of an onerous annual expense in respect to a business that it proposed to and did carry on, and such payment was made in the course of such continuing business; and that as a result no advantage or benefit either positive or negative accrued to the capital account of the appellant, but instead all the advantage and benefit obtained was of a revenue character and, therefore, the payment was not a capital outlay within the meaning of section 12(1)(*b*) of *The Income Tax Act*.

The appeal, therefore, is allowed with costs.

Judgment accordingly.