1958

Mar. 17-20, 24-25

Dec. 24

BETWEEN:

IMPERIAL OIL LIMITED ..... APPELLANT;

AND

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

Revenue—Income tax—The Income Tax Act, S. of C. 1948, c. 52, ss. 11(1)(b), 11(1)(f), 12(1)(a), 12(1)(b), 12(1)(h), 106—Income Tax and Income War Tax Amendment Act, S. of C. 1949, 2nd Sess., c. 25, s. 53, as amended by S. of C. 1950, c. 40—The Income Tax Regulations, as amended by Order in Council P.C. 4443, dated August 29, 1951, ss. 1200, 1201—Deductible allowance in respect of oil or gas well—Computation of base for deductible allowance on individual producing well basis—Aggregate of losses to be deducted from aggregate of profits—Subsections (1) and (5) of section 1201 of Regulations to be read together—Subsection (4) intra vires—Deduction under subsection (5) limited to amount of expenditures reasonably attributable to production of oil or gas from well.

The appellant is engaged in the production of oil and gas, the marketing of petroleum products and other related activities. In 1951, it carried on an extensive programme for the exploration and development of oil and gas wells. In computing its income for that year it claimed that the amount of the deductible allowance to which it was entitled under section 11(1)(*b*) of *The Income Tax Act*, 1948 and section 1201 of The Income Tax Regulations was $13,023,666.59, being 33⅓ per cent of $39,070,999.79, the amount of its profits in 1951 from the production of oil or gas from its producing wells that it operated at a profit in 1951, on the ground that that was the amount of its profits for 1951 that were reasonably attributable to the production of oil or gas from its profitable producing wells. Alternatively, it claimed that if the aggregate of its profits from its profitable producing wells must be reduced, pursuant to subsection (4) of section 1201 of the Regulations, by the aggregate of its losses from the production of its producing wells that it operated at a loss in 1951, which amounted to $8,066,012.55, the base of its deductible allowance would be $31,004,987.24 and the amount of its deductible allowance $10,334,995.74.

The appellant's producing department was conducted as a separate entity and the accounts of its producing wells, whether operated profitably or at a loss, were kept on an individual well basis. The profit or loss from each well was determined after charging to it various direct and indirect charges, including the exploration and development expenses directly related to it. The purpose of this system was to determine in the case of each well the profit of the appellant, if any, that was "reasonably attributable to the production of oil or gas from the well".

In assessing the appellant, the Minister fixed the amount of its deductible allowance at $790,067.36, being 33⅓ per cent of $2,370,202.07, which he considered to be the amount of its aggregate profits for 1951 from the production of oil or gas from all its wells, whether producing or not or whether profitable or not. In arriving at this amount the Minister reduced the base of $31,004,987.24 relied upon by the appellant by two amounts, of which the first was $19,992,588.33, being the amount of the

appellant's drilling, exploration and other costs in 1951, which it contended was unrelated and, therefore, not "reasonably attributable" to the production of oil or gas from any of its producing wells, but which the Minister deducted under section 53 of the 1949 Act, as amended, on the ground that they were reasonably attributable to the production of oil or gas in 1951, and the second was $8,642,196.84 being unrealized profit in supply, manufacturing and marketing inventories. The appellant appealed against the assessment.

Held: That the computation of the base for the deductible allowance to which the appellant is entitled under section 1201 of The Income Tax Regulations must be made on an individual producing well basis, and, since the appellant operated more than one well, that computation is subject to the definition of the base set out in subsection (4) of the section.

2. That when subsections (1), (4) and (5) of section 1201 of the Regulations refer to profits "reasonably attributable" to the production of oil or gas it is the production of oil or gas from a producing well that must be considered.

3. That in determining whether there were profits that were "reasonably attributable" to the production of oil or gas from a well subsections (1) and (5) of section 1201 of the Regulations must be read together.

4. That section 53 of the 1949 Act, as amended, allows the deduction for income tax purposes of certain items of expenditure, such as all the costs of drilling, which, ordinarily, would be of a capital nature and not deductible as items of operating expense, and subsection (5) of section 1201 of the Regulations requires it in the computation of the base for the deductible allowance, but the opening words of subsection (5), namely, "In computing the profits reasonably attributable to the production of oil or gas for the purpose of this section" plainly limit the compellable deduction of amounts allowed to be deducted under section 53 to amounts of expenditures that are "reasonably attributable" to the production of oil or gas from the well under consideration, and does not require the deduction of amounts of expenditures that are not clearly related to the production of oil or gas from the well.

5. That for the purpose of determining the net result under subsection (4) of section 1201 of the Regulations it is necessary in each case to deal with the well under subsection (1) to ascertain whether there were any profits for the year "reasonably attributable" to the production of oil or gas from it in that year or whether there was a loss.

6. That the proper approach to the ascertainment of the effect of subsection (4) on the computation of the base for the deductible allowance permitted by the section is to look first at subsection (1) and then at subsection (5) to ascertain the individual profits and the individual losses that were "reasonably attributable" to the production from each producing well and then, pursuant to subsection (4), determine the aggregate of the profits and the aggregate of the losses and deduct the latter from the former, the net result constituting the base for the computation of the appellant's deductible allowance.

7. That the profits of the appellant for 1951 that were reasonably attributable to the production of oil or gas from its profitable producing wells amounted in the aggregate to $39,070,999.79 and that its losses for 1951 that were reasonably attributable to the production of oil and gas from its loss producing wells amounted in the aggregate to

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$8,066,012.55 and that, pursuant to subsection (4) of section 1201 of the Regulations, the net result of $31,004,987.24 was the amount of the appellant's profits for 1951 that were reasonably attributable to the production of oil or gas in 1951 from all the wells operated by it in that year.

8. That the power to enact a regulation determining the amount of the deductible allowance permitted by section 11(1)(*b*) of the Act was granted in the broadest terms, that the section does not specify what the base for the computation of the allowance should be or its amount and that subsection (4) of section 1201 of the Regulations is within the authority of section 11(1)(*b*) of the Act.

9. That the ascertainment of the appellant's profits "reasonably attributable" to the production of oil or gas from its wells necessarily involves a computation of the expenditures reasonably attributable to such production as well as that of the receipts reasonably attributable to it, that if an expenditure is to be chargeable against a well it must be shown that it was incurred in 1951 and was "reasonably attributable" to the production of oil or gas from such well in that year and that whether a particular expenditure was "reasonably attributable" to such production must, of necessity, be a question of fact and its determination must depend, largely at any rate, on the opinions of persons qualified to express them.

10. That the amount of $19,992,588.13 which the Minister deducted from the base of $31,004.987.24 on which the appellant relied represented drilling, exploration and other costs that were not related to the production of oil or gas from any of the appellant's wells and were not charges that could properly be charged against any producing well, that it could not be said that they were reasonably attributable to any production and that the Minister had no right to deduct the amount or any portion of it from the amount of the appellant's profits.

11. That the amount of $8,642,196.84 which the Minister deducted from the base of $31,004,987.24 on which the appellant relied represented unrealized profits in supply, manufacturing and marketing inventories that had passed away from the appellant's producing department as if they had been sold to a third party and that the Minister had no right to deduct the amount from the appellant's profits reasonably attributable to the production of oil or gas from its wells.

12. That the appeal from the assessment must be allowed.

APPEAL under the *Income Tax Act*.

The appeal was heard by The President of the Court at Ottawa.

A. S. Pattillo, Q.C., A. J. MacIntosh, J. B. Tinker and *J. G. MacDonell* for appellant.

Terence Sheard, Q.C., and *T. Z. Boles* for respondent.

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

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THE PRESIDENT now (December 24, 1958) delivered the following judgment:

The appellant has appealed against its income tax assessments for 1951, 1952 and 1953 but it was agreed between counsel that the Court should now hear only its appeal against the 1951 assessment and that its appeals against the assessments for 1952 and 1953 should stand over.

The notice of appeal sets out two independent grounds of appeal, one relating to the amount of the deductible allowance to which the appellant was entitled under section 11(1)(*b*) of *The Income Tax Act*, Statutes of Canada, 1948, Chapter 52, as amended, and section 1201 of The Income Tax Regulations, hereinafter called section 1201 of the Regulations, enacted under the authority of section 106 of the Act and amended by Order in Council P.C. 4443, dated August 29, 1951, and the other to the amount which it was entitled to deduct under section 11(1)(*f*) of the Act by reason of its contribution to its employees' superannuation fund or plan. The subject matter of the latter ground of appeal has been dealt with recently in this Court by Kearney J. in *Minister of National Revenue v. The Ontario Paper Company Limited*[1], a judgment now under appeal to the Supreme Court of Canada, and it was agreed between counsel that the final result in that case should bind the parties hereto in respect thereof. Consequently, it stands in abeyance, so that this appeal is confined to consideration of the amount of the deductible allowance to which the appellant was entitled in 1951 under section 11(1)(*b*) of the Act and section 1201 of the Regulations.

The appellant's right to a deduction allowance stems from section 11(1)(*b*) of the Act which provides:

> 11. (1) Notwithstanding paragraphs (*a*), (*b*) and (*h*) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year:
>
> (*b*) such amount as an allowance in respect of an oil or gas well, mine or timber limit, if any, as is allowed to the taxpayer by regulation,

In view of the opening words of the section it is, strictly speaking, not necessary to set out paragraphs (*a*), (*b*) and

[1] [1958] Ex. C.R. 52.

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(*h*) of subsection (1) of section 12 but, *ex abundanti cautels*, I do so. They read as follows:

12. (1) In computing income, no deduction shall be made in respect of

(*a*) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,

(*b*) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part,

(*h*) personal or living expenses of the taxpayer except travelling expenses (including the entire amount expended for meals and lodging) incurred by the taxpayer while away from home in the course of carrying on his business.

The regulation referred to in section 11(1)(*b*) of the Act is section 1201 but it is preceded by section 1200, which is in the following terms:

1200. For the purposes of paragraph (*b*) of subsection (1) of section 11 of the Act there may be deducted in computing the income of a taxpayer for a taxation year amounts determined as hereinafter set forth in this Part.

Then section 1201, in its original form, provided as follows:

1201. (1) Where the taxpayer operates an oil or gas well, or where the taxpayer is a person described as the trustee in subsection (1) of section 73 of the Act, the deduction allowed for a taxing year is 33⅓ per cent of the profits of the taxpayer for the year reasonably attributable to the production of oil or gas from the well.

(2) Where a person, other than the operator of an oil or gas well and the person described as the trustee in section 73 of the Act, has an interest in the proceeds from the sale of the products of the well or an interest in income from the operating of the well, the deduction allowed for a taxation year is 25 per cent of the amount in respect of such interest included in computing his income for the year.

(3) Where an amount received in respect of an interest in the income from the operation of a well is dividend or is deemed by section 73 of the Act to be a dividend, no deduction shall be allowed under subsection (2) of this section.

(4) In computing the profits reasonably attributable to the production of gas or oil for the purpose of this section a deduction shall be made equal to the amounts, if any, deducted from income under the provisions of section 53 of Chapter 25 of the Statutes of 1949, Second Session, in respect of the well.

This was the state of section 1201 immediately prior to its revocation and re-enactment by Order in Council P.C. 4443, dated August 29, 1951, *vide* Canada Gazette, Vol. 85, 1951, Part II, September 12, 1951, made applicable to 1951 and subsequent years. In its amended form, section 1201 reads as follows:

1201. (1) Where the taxpayer operates an oil or gas well the deduction allowed for a taxation year is 33⅓ per cent of the profits of the tax-

payer for the year reasonably attributable to the production of oil or gas from the well.

(2) Where a person, other than an operator, has an interest in the proceeds from the sale of the products of an oil or gas well or an interest in income from the operation of the well, the deduction allowed for a taxation year is 25 per cent of the amount in respect of such interest included in computing his income for the year.

(3) Where an amount received in respect of an interest in the income from the operation of a well is a dividend or is deemed by the Act to be a dividend, no deduction shall be allowed under this section.

(4) Where the taxpayer operates more than one oil or gas well, the profits referred to in subsection one shall be the aggregate of the profits minus the aggregate of the losses of the taxpayer for the year reasonably attributable to the production of oil or gas from all wells operated by the taxpayer.

(5) In computing the profits reasonably attributable to the production of oil or gas for the purpose of this section a deduction shall be made equal to the amounts, if any, deducted in computing the taxpayer's income for the taxation year under the provisions of section 53 of Chapter 25 of the Statutes of 1949, Second Session.

And section 53 of Chapter 25 of the Statutes of 1949, Second Session, as amended by Chapter 40 of the Statutes of 1950, being an *Act to Amend The Income Tax Act and the Income War Tax Act*, hereinafter called the 1949 Act, provided:

53. (1) A corporation whose principal business is production, refining or marketing of petroleum, petroleum products or natural gas or exploring or drilling for petroleum or natural gas may deduct in computing its income, for the purposes of The Income Tax Act, the lesser of

(*a*) the aggregate of the drilling and exploration costs, including all general geological and geophysical expenses, incurred by it, directly or indirectly, or in respect of exploring or drilling for oil and natural gas in Canada

(i) during the taxation year, and

(ii) during previous taxation years, to the extent that they were not deductible in computing income for a previous taxation year, or

(*b*) of that aggregate an amount equal to its income for the taxation year

(i) if no deduction were allowed under paragraph (*b*) of subsection one of section eleven of the said Act, and

(ii) if no deduction were allowed under this subsection,

minus the deduction allowed by section twenty-seven of the said Act.

The issues in the appeal appear succinctly in a reconciliation statement, filed as Exhibit 76, prepared by Mr. G. L. McLellan, the appellant's assistant comptroller, who was in charge of the accounting of its producing department and kept its accounts as if it were a separate entity. The appellant claims that the amount of the deductible allowance to which it was entitled for 1951 is $13,023,666.59, being 33⅓

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per cent of $39,070,999.79, the amount of its profits for 1951 from the production of oil or gas from its producing wells that it operated at a profit in 1951. On the other hand, the Minister fixed the amount of its deductible allowance at $790,067.36, being 33⅓ per cent of $2,370,202.07, which he considered to be its profits for 1951 from the production of oil or gas from all its wells, whether producing or not and whether profitable or not. There is thus a great difference in the amount of the base from which the amount of the deductible allowance is to be computed.

The appellant contends, primarily, that it should be $39,070,999.79, being the amount of its profits for 1951 reasonably attributable to the production of oil or gas from the 857 producing wells that it operated at a profit in 1951, called its profitable producing wells. Alternatively, it claims that if the aggregate of its profits from its profitable producing wells must be reduced, pursuant to subsection (4) of section 1201 of the Regulations, by the aggregate of its losses from the 228 producing wells that it operated at a loss in 1951, called its loss producing wells, the base of its deductible allowance will be reduced by $8,066,012.55, being the aggregate of its losses from its loss producing wells, leaving a base of $31,004,987.24, on which the appellant's deductible allowance would be $10,334,995.74.

But the Minister determined that the base of $31,004,-987.24 should be reduced by all the expenses that were chargeable for income tax purposes under section 53 of the 1949 Act, as amended. He reduced the base contended for by the appellant by two substantial amounts. The first of these was $19,992,588.33, being the amount of the appellant's drilling, exploration and other costs in 1951, which the appellant contends were unrelated and, therefore, not reasonably attributable to the production of oil or gas from any of its producing wells, within the meaning of section 1201 of the Regulations, but which the Minister deducted from its profits, purporting to do so under the authority of section 53 of the 1949 Act, as amended. The other amount was $8,642,196.84, being, as the Minister considered, unrealized profit in supply, manufacturing and marketing inventories, but being in reality the amount of the crude oil and petroleum products held by departments of the appellant other than its producing one, an over-all inventory adjustment that will be explained later.

The reduction of the two amounts referred to brought the Minister's base for the computation of the appellant's deductible allowance down from $31,004,987.74 to $2,376,202.07 and 33⅓ per cent of this amount came to $790,067.36, which he held to be the amount of the appellant's deductible allowance.

Put alternatively, the appellant added back to the base of $2,376,202.07, used by the Minister for the computation of its deductible allowance, the two amounts of $19,992,588.33 and $8,642,196.84.

The appeal raises several questions of great importance from a financial point of view by reason of the magnitude of the amount involved. If the appellant succeeds in all its contentions it will be entitled to deduct from its taxable income for 1951 the sum of $13,023,666.95 instead of the sum of $790,067.36 and, since it has paid income tax on the amount of the assessment it will be entitled to a refund of the tax which it has overpaid. When this case was set down for trial I was informed by counsel that the issues were similar, except for the amounts involved, in the case of the assessments for the years 1952, 1953, 1954, 1955 and 1956 to those in the present case and that if the appellant succeeded throughout the total amount of the refunds to which it would be entitled would be in the neighborhood of $40,000,000.

The questions involved in the appeal fall to be determined in a natural order. The primary question is whether the appellant is entitled to have its deductible allowance under section 11(1)(*b*) of the Act and section 1201 of the Regulations computed on the basis of the profits from each of its producing wells dealt with individually. The determination of this question involves consideration of whether and to what extent the decision of the Supreme Court of Canada in *Home Oil Company Ltd. v. Minister of National Revenue*[1] is applicable to the present case, in view of the fact that section 1201 of the Regulations in its amended form is different in terms from the section that the Supreme Court had to consider in the *Home Oil* case.

The next question is subsidiary to the primary one, namely, whether the appellant, notwithstanding subsection (4) of section 1201 of the Regulations, is entitled to have the computation of its deductible allowance based solely

[1] [1955] S.C.R. 733.

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on the profits from its profitable producing wells without deduction of the losses of its loss producing wells. The determination of this question involves consideration of whether subsection (4) of section 1201 of the Regulations is *ultra vires,* as counsel for the appellant contended.

There are two other questions of a different nature. The first is whether the Minister in determining the amount of the appellant's profits for 1951 reasonably attributable to the production of oil or gas from its wells had any right to deduct the amount of $19,992,588.33, being the amount of its exploration and other costs incurred in 1951 that were not related to the production of oil or gas from any of its wells in 1951.

Finally, it must be determined whether the Minister, in determining the base for the computation of the appellant's deductible allowance, had any right to deduct the inventory adjustment of $8,642,196.84.

Before I deal specifically with these questions, I should summarize the evidence adduced on behalf of the appellant as to its oil and gas activities in 1951. This was given by Mr. W. D. C. Mackenzie, the appellant's general manager of its producing department, Mr. J. D. Macgregor, Mr. Mackenzie's adviser on matters pertaining to exploration for oil and gas in Canada, Mr. W. J. Gibson, the appellant's operations adviser to its producing department in Toronto, Mr. W. Roliff, the appellant's manager of the eastern division of its producing department, and Mr. E. H. Vallat, an experienced oil consultant. Counsel for the respondent did not call any witnesses and suggested that much of the evidence adduced for the appellant was irrelevant to the issues before the Court. I do not agree. In my opinion, their evidence has an important bearing on some of the questions that I have enumerated. Moreover, in view of the fact that the issues involve considerations of such monetary magnitude that an appeal to the Supreme Court of Canada from the decision of this Court, no matter what it may be, is a certainty, I believe that this Court should set out its findings on the basis of the evidence for what they may be worth. The same will be true of the accounting evidence to which reference will be made later.

The appellant had its head office at Sarnia and its executive office at Toronto. The evidence establishes that it ran its several activities by departments, one of which, and the

only one with which we are concerned in this case, was its producing department. It conducted this department, as it also did each of its other departments, as if it was a separate entity and kept the accounts of its producing department accordingly. Certainly, for the purpose of determining the amount of the deductible allowance to which the appellant was entitled under section 11(1)(*b*) of the Act and section 1201 of the Regulations this course was proper. Indeed, it is difficult to see how it could properly have been determined otherwise.

The producing department had two divisions, one in Western Canada with its headquarters at Calgary and the other in Eastern Canada with its headquarters at London. The producing department had two sections, one concerned with exploration and the other with development.

I shall deal first with the activities of the producing department in Western Canada. The lands in which the appellant had an interest were extensive, as appears from a map, filed as Exhibit 1. Its exploration section in Western Canada had district offices at Edmonton, Regina and Peace River and its development section had offices at Devon and Redwater near Edmonton.

It was the practice of the appellant to budget in each year for the exploration and development work to be done in the following year and in accordance with this practice it had in 1950 planned an exploration programme for 1951 in three areas, one in South-western Manitoba and South-eastern Saskatchewan, another in the greater Edmonton area and the third in Northern Alberta. It had also planned a development programme almost entirely in the greater Edmonton area in the Leduc and Redwater fields. The extent of the programmes is indicated by the fact that the budget contemplated an expenditure of approximately $15,000,000 for exploration and approximately $20,000,000 for development.

Here I should set out what is meant by the terms "exploration" and "development" as they are understood in the industry. Exploration takes two forms, one being primary exploratory work and the other exploratory drilling. Primary exploratory work is done in an area that has not previously been explored and in which there has not been any clear indication of the presence of oil or gas. It consists essentially of work of a geophysical character, such as

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seismic, gravity-meter and aerial magnetometer surveys, but it also includes work of a geological nature, such as structure test drill surveys, that is to say, shallow sub-surface geologic oil investigations designed to show the geological character of the deeper sub-surface, and general surface geological surveys. Then, if the geophysical or geological indications so suggest exploratory drilling is done in the hope of finding oil or gas in an area in which it has not previously been found. Then, there may be velocity surveys in holes that may have been drilled in order to determine the volicity of sound waves through the rock formations in aid of the interpretation of such seismic surveys as have been made. In addition to its aerial surveys, the appellant did some photogeology work, that is to say, it took some aerial photographs of the ground in order to assist in the determination of its geological character. Photogeology work is a reconnaissance guide to surveys.

If a well is drilled and produces oil or gas it is called a discovery well. In the area of such discovery the development section then takes over and development drilling is done in it for the purpose of developing whatever oil reserves there may be in it.

Mr. Macgregor drew a vivid picture of the geology of the sedimentary basin in Western Canada in which its oil and gas fields lie. Oil and gas are mineral substances, hydrocarbons, that occur within the sedimentary rocks that overlie the igneous rocks, which together form the sixty mile thick crust of the earth. The sedimentary rocks occur in sedimentary basins and the prairies of Western Canada constitute its principal sedimentary basin, bounded on the east by the igneous Pre-Cambrian shield and on the west by the Rocky Mountains. Oil and gas are found in the sedimentary rocks in this basin. There are a million cubic miles of such rocks. These are classified according to the era in which they were formed, the oldest being immediately above the igneous rocks and the youngest nearest the surface.

The presence of oil or gas depends on three conditions. Firstly, there must have been a source from which it was created. Oil and gas are hydrocarbons and it is generally believed that they had an organic source, the disintegration and decomposition of plant and animal creatures. Secondly, the rock formations must have sufficient porosity to accommodate the products thus created. Here it should be noted

that oil does not exist in the form of a lake or pool. It occurs in the cavities or pores of rocks whose formation might be likened to that of sponges. The porosity of rocks is measured in terms of percentage of the pores to the total rock. Finally, the oil or gas must be trapped, that is to say, there must be a condition in the rocks that prevents the migration of the oil or gas. Consequently, the object of exploration is to discover such traps.

There are three types of such traps. The first is a structural one, called anticline, in which the movement of the earth has caused the rocks to be deformed in such a way as to contain the oil or gas and prevent it from migration, such as the Turner Valley field. A second type is called stratigraphic and occurs where the geological condition is such that the rock porosity disappears and sand takes its place, an example of which is found in the Pembina field. The third type of oil field trap is organic, of which a coral reef is an example, it being considered that organisms built it. In Western Canada the Devonian coral reefs are of particular importance. A great part of the appellant's exploration in 1951 was concentrated on the Devonian coral reef in the Leduc area.

It should be emphasized that there is no such thing as a direct oil finding method. Exploration for oil and gas is indirect. As already stated, there must first be an exploratory survey for the geological conditions that must exist for the presence of oil or gas. But, even when the geologic conditions seem favorable, there is no certainty that oil or gas will be found and its actual presence cannot be definitely ascertained until after an exploratory well has been drilled. The most important of the surface exploratory surveys in Western Canada is the seismic survey. Its purpose is to assist in the ascertainment of the existence and character of the rocks or reefs in which oil or gas may be found, without actually drilling an exploratory well. Mr. Macgregor explained the operation of a seismic survey and it was portrayed on a sketch, filed as Exhibit 41. It need not be described in detail for the purposes of this case. It is sufficient to say that a shallow hole is drilled and a charge of dynamite is exploded in it. This creates an artificial earthquake and the sound waves generated by the explosion penetrate into the sub-surface and are reflected back to the surface as they strike the various classes of rock. The times

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of the various reflections are picked up by geophones at the surface and the results recorded in what is called a seismogram. It is important to have velocity surveys in order to determine the velocity of the seismic waves so that the results of the seismic survey may be correctly interpreted. By this method information is obtained relating to the subsoil rock formations in the area in which the seismic survey is made.

In connection with its surveys the appellant acquired from other companies the results of the velocity surveys made by them. A complete list of the velocity survey costs cleared to leasing and exploration expense for the year ended December 31, 1951, was filed as Exhibit 43. This shows the amounts paid to other companies for the velocity surveys run by them, including late charges in 1951 for velocity surveys run in previous years, and also the velocity surveys conducted by the appellant itself showing the costs incurred by it in respect of them.

In connection with its exploratory work the appellant also made contributions to test wells drilled by its competitors on lands adjacent to its own for the purpose of obtaining the results of such wells. The location of such test wells is shown on a map, filed as Exhibit 6, and a complete list of the appellant's test well contributions in 1951 and their amounts was filed as Exhibit 44.

The exploration and development programmes for 1951 proceeded substantially as planned but with varying results. The exploration work in South-western Manitoba and South-eastern Saskatchewan, which was of a primary exploratory nature, except that some drilling was done in Manitoba, was disappointing. The results in the greater Edmonton area, where primary exploratory work had been practically completed in 1950, were generally discouraging, except that some gas wells were discovered. And in Northern Alberta, although some wells were drilled, the exploration work was all unsuccessful except that one oil well was discovered. Altogether, the appellant's exploration work in 1951 in Western Canada resulted in 1 oil discovery, 11 gas discoveries and 33 dry holes. In addition, there were 16 wells that were incomplete at the end of the year and there were late charges in the year against 22 wells that had been drilled previously. The locations of the wells and holes

referred to are shown on a map, filed as Exhibit 3, and the summary of the results of the exploratory drilling is set out in Exhibit 50.

A list of the 45 exploratory wells drilled by the appellant in 1951 was filed as Exhibit 45. This shows the location of each well, the date when it was spudded in, that is to say, when drilling was commenced, and the date of its completion. There was also a list, filed as Exhibit 46, showing the 16 wells that were spudded in during 1951 but were incomplete at the end of the year or in respect of which preparatory costs had been incurred in 1951, although drilling did not commence until later, and also of 22 wells completed prior to 1951 in respect of which late charges were incurred in 1951.

There was a similar list, filed as Exhibit 47, which included wells which were not operating in 1951 by reason of having been shut-in or capped. A shut-in well is one that has proved itself capable of production but its production, for some reason or other, has been prevented or "shut-in". If the well is a gas well the corresponding term is "capped", that is to say, the production valves are closed.

On the other hand, the development work in 1951 in Western Canada met with a high measure of success. It resulted in 289 oil wells, 2 gas wells and 12 dry holes. In addition, there were 77 wells that were incomplete at the end of the year and there were late charges in the year against 213 wells that had been drilled previously. The locations of the wells and holes are shown on a map filed as Exhibit 3 and the summary of the results of the development drilling is set out in Exhibit 50.

The locations of the appellant's exploration and development work in 1951 in Western Canada and the nature of the work done were all shown on maps and overlays filed as Exhibits 2 to 27 inclusive.

The appellant also carried on exploration and development work in 1951 in Eastern Canada, mostly in Southwestern Ontario, west of Toronto and Hamilton and north to Georgian Bay. There was also some surface exploration activity in the Atlantic provinces. The lands in which it had an interest are shown on a map, filed as Exhibit 28. William Roliff, the appellant's manager of the eastern division of its producing department and consequently, responsible for its exploration and development activities in Eastern Canada,

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gave evidence of its activities in 1951 in Eastern Canada. There, the problem was to find the reefs in which oil or gas occurred and resort was had to gravity-meter and subsurface geology surveys, rather than to seismic surveys which did not give sufficienlty valuable results. The gravity-meter surveys were more successful because of the differences in density of the rock column which comprised the reef and sediments and the rock column adjoining the reef. Mr. Roliff filed a number of exhibits in the course of his evidence, showing the activities in 1951 in Eastern Canada, namely, a list of exploratory wells, as Exhibit 66; a list of development wells, as Exhibit 67; a list of incomplete drilling and preparatory costs, as Exhibit 68; a similar list but including shut-in wells, as Exhibit 69; a list of late charges on wells completed in prior years, as Exhibit 70; a similar list but including shut-in wells, as Exhibit 71; a list of 1951 late charges on wells completed in prior years, as Exhibit 72; and a similar list but including shut-in wells, as Exhibit 73. The results of the drilling activity in 1951 in Eastern Canada were set out in a table, filed as Exhibit 75. The exploratory drilling resulted in 5 gas discoveries, 16 dry holes, 4 wells that were incomplete at the end of the year and 24 cases of late charges to previously drilled wells. The development drilling resulted in 1 oil well, 4 gas wells, 15 dry holes, 3 wells that were incomplete at the end of the year and 32 cases of late charges to previously drilled wells. The locations of the exploration and development work in 1951 in Eastern Canada and the nature of the work done were all shown on maps and overlays filed as Exhibits 29 to 35 inclusive.

Mr. W. J. Gibson, the appellant's operations adviser to its producing department at Toronto, who was its division petroleum engineer at Calgary in 1951, gave evidence relating to the appellant's development activities in Western Canada in 1951. He described in detail the manner in which a well was drilled and explained the various operations that took place in the course of the drilling, these being illustrated by schematic sketches filed as Exhibits 52 to 56 inclusive. It is not necessary to set out their description.

Mr. Gibson also explained how a well was put on production after it had been drilled and oil or gas had been found. The practice was to flow the well into what is called a central battery, which is a group of tanks. The fluid which

may contain gas and water as well as oil flows from the well through a flow line to a separator. Any gas is taken off at the top, passes through a meter where it is measured and then to a gas line where it goes to the market or is flared if there is no market. Any water at the bottom is drained off and the oil flows into a storage tank from which it goes to a pipe line. Several wells, up to sixteen or twenty, may be produced into a single battery. The regulations require that the amounts of oil, gas and water from each well should be measured. Mr. Gibson explained in detail how the production of each well was determined. It is not necessary to elaborate his explanation beyond saying that the producing rate of each well expressed in terms of barrels per hour is established. But, since the producing characteristics of wells vary from well to well and the flow from a single well may vary from time to time, one or two tests per month are run. The total quantity of oil from each well is determined in a manner explained by Mr. Gibson. There is no dispute on this subject.

I now come to the primary question in this appeal, namely, whether the computation of the base for the deductible allowance to which the appellant is entitled is to be made on an individual producing well basis as the appellant contends or on an aggregate basis as the Minister asserts. There is no doubt in my mind that the former basis is the proper one. A similar question arose in *Home Oil Company Limited v. Minister of National Revenue*[1] in which section 1201 of the Regulations in its original form was considered. In this Court I held that the amount of the allowance to which the appellant in that case was entitled under subsection (1) of section 1201 of the Regulations, as it then stood, was fixed under subsection (4) by the amount of the expenditures which it had deducted under section 53 of the *Income Tax Amendment Act,* 1949 and that, since it had deducted all its exploration and development expenditures under that section, subsection (4) of section 1201 required that the same amount of expenditures must be deducted in computing its profits for the purpose of subsection (1) and that the profits contemplated by subsection (1) were the aggregate, over-all profits from the production of oil and gas from all the appellant's wells. The Supreme

[1] [1954] Ex. C.R. 633; [1955] S.C.R. 733.

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Court of Canada unanimously reversed my judgment and allowed the appellant's appeals from the 1949 and 1950 assessments. Rand J., delivering the judgment of the Court, held that in computing the appellant's deductible allowance its producing wells must be dealt with individually, that unless the items of expenditure under section 53 of the Act of 1949 were clearly related to a profitable producing well they were not to be taken into account in determining the allowance under Regulation No. 1201 in respect of that well, and that the profits from the profitable producing wells were not subject to deduction of the losses of the loss producing wells.

The Court has now to consider section 1201 of the Regulations in its amended form. Subsection (1) remains substantially as it was but two changes have been made. Subsection (4) has been added and the concluding words of subsection (4), now subsection (5), "in respect of the well" have been omitted.

I have no hesitation in finding that in determining the base for the computation of the appellant's deductible allowance under the present section 1201 of the Regulations it is just as important that each producing well should be dealt with individually as it was under the section in its former state.

The importance of the words "reasonably attributable" in subsections (1), (4) and (5) of section 1201 cannot be too strongly stressed. It is concerned only with producing wells. It is the production of oil or gas from a producing well that must be considered. And since, under subsection (1), the base for the computation of the deductible allowance is $33\frac{1}{3}$ per cent of the profits of the appellant for the year "reasonably attributable" to the production of oil or gas in the year from its producing well, it follows, of necessity, that it must be determined in the case of each producing well whether there were any profits in the year that were "reasonably attributable" to the production of oil or gas from it in the year. This involves an ascertainment in each case of the revenues derived from the production of oil or gas from it and of the expenditures incurred in such production. Both the revenues and the expenditures must be "reasonably attributable" to the production.

In this connection the opinion of Rand J. in the *Home Oil* case (*supra*) that unless an item of expenditure under sec-

tion 53 of the 1949 Act is clearly related to a profitable producing well it is not to be taken into account in determining the allowance under Regulation No. 1201 in respect of that well, is just as applicable under the present section as it was under the section as it stood when the judgment of the Supreme Court of Canada was rendered. And the principle must be similar in the case of a loss producing well.

I agree, therefore, with the submission of counsel for the appellant that in determining whether there were profits that were "reasonably attributable" to the production of oil or gas from a well, subsections (1) and (5) of section 1201 of the Regulations must be read together.

The purpose of subsection (5) is to require the deduction of the amounts of certain items of expenditure related to the production of oil or gas from the well that would not ordinarily enter into the computation of profits but are allowed to be deducted by section 53 of the 1949 Act, such as all the costs of drilling the well that were incurred in the year. Ordinarily, such costs would be of a capital nature and not deductible as items of operating expense. But section 53 allows their deduction for income tax purposes and subsection (5) of section 1201 of the Regulations requires it in the computation of the base for the deductible allowance. But the opening words of subsection (5), namely, "In computing the profits reasonably attributable to the production of oil or gas for the purpose of this section" plainly, in my opinion, limit the compellable deduction of amounts allowed to be deducted under section 53 to amounts of expenditures that are "reasonably attributable" to the production of oil or gas from the well under consideration, and does not require the deduction of amounts of expenditure that are not "clearly related", as Rand J. put, to the production of oil or gas from the well. As I see it, the only amounts of deductible expenditures under section 53 of the 1949 Act that are required to be deducted under subsection (5) are those that are "reasonably attributable" to the production of oil or gas from the well. If they are not so "reasonably attributable" subsection (5) does not require their deduction and they are not to be taken into account in determining the base for the computation of the appellant's deductible allowance.

Moreover, the use of the words "amounts, if any," in subsection (5) further points to the need of an individual well

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basis for the computation of the allowance and negatives the contention of counsel for the respondent that subsection (5) requires the deduction of the total of the amounts that were deducted under section 53 for income tax purposes, regardless of whether they are attributable to the production of oil or gas from a well or not. Such a contention would render the opening words of subsection (5) meaningless. I shall refer to subsection (5) further when I deal with the item of $19,992,588.33 of unrelated drilling, exploration and other costs.

In section 1201 of the Regulations as it stood prior to its amendment the base for the computation of the deductible allowance permitted by it was the profits "reasonably attributable" to the production of oil or gas from its profitable producing wells dealt with individually, without deduction of the losses of its loss producing wells. The amended section was designed to change this and it did so by subsection (4) which defined the profits referred to in subsection (1) in cases where the taxpayer operated more than one oil well as the aggregate of the profits minus the aggregate of the losses of the taxpayer for the year "reasonably attributable" to the production of oil or gas from all the wells operated by him. This subsection plainly points to the necessity of dealing with each producing well individually. It must be ascertained in the case of each well whether it operated at a profit or at a loss and in each case the revenues and expenditures that were "reasonably attributable" to the production of oil or gas from the well must be determined. It would be impossible to fix the aggregate of the profits of the profitable producing wells without first ascertaining the profits of each profitable producing well singly, and the aggregate of the losses of the loss producing wells could not be determined without first ascertaining the losses of each loss producing well singly. The determination of an aggregate necessarily implies the determination of the items that combine to make it up. Thus, for the purpose of determining the net result under subsection (4) it is necessary in each case to deal with the well under subsection (1) to ascertain whether there were any profits for the year "reasonably attributable" to the production of oil or gas from it in that year or whether there was a loss. And here I also agree with counsel for the appellant in his submission that the proper approach to the ascertainment of the effect of

subsection (4) on the computation of the base for the deductible allowance permitted by the section is to look first at subsection (1) and then at subsection (5) to ascertain the individual profits and the individual losses that were "reasonably attributable" to the production from each producing well and then, pursuant to subsection (4), determine the aggregate of the profits and the aggregate of the losses and deduct the latter from the former, the net result constituting the base for the computation of the appellant's deductible allowance. And in this connection my remarks concerning the application and construction of subsection (5) apply as they did previously.

Thus, in my opinion, the conclusion is inescapable that the computation of the base for the deductible allowance to which the appellant is entitled under section 1201 of the Regulations must be made on an individual well basis, subject to the fact that since the appellant operated more than one well the base for the computation of the deductible allowance must be that defined by subsection (4).

Having come to this conclusion I proceed to consideration of the evidence of the amounts of the appellant's profits from its profitable producing wells and the amounts of its losses of its loss producing ones that were respectively "reasonably attributable" to its production of oil or gas from them. The evidence was primarily that of Mr. G. L. McLellan, the appellant's assistant comptroller, to whom reference has already been made. Counsel for the appellant also called two outstanding chartered accountants from Toronto in support of Mr. McLellan's conclusions, Mr. W. L. McDonald, a senior partner of Price, Waterhouse & Company, and Mr. G. G. Richardson, a senior partner of Clarkson, Gordon & Company.

Mr. McLellan gave a detailed description of how the accounts of the appellant's producing department were kept. The basic principle of the accounting was that the department was treated as if it were a separate entity and the accounts of the producing wells, whether profitable producing wells or loss producing wells, were kept on an individual well basis, with a view to determining in each case the profits of the appellant, if any, "reasonably attributable to the production of oil or gas from the well." The evidence was that in 1951 the appellant had 1,085 producing wells, of which 857 were operated at a profit and 228 at a

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loss. The accounts of all these wells were gathered together in three volumes, filed as Exhibits 79a, 79b and 79c. The first volume, Exhibit 79a, included the accounts of the wells in the Redwater field, the second, Exhibit 79b, those of the wells in the other parts of Western Canada and the third, Exhibit 79c, those of the wells in Eastern Canada. It was shown in the case of each producing well whether it was a profitable producing well or a loss producing one. Each account showed the items of revenue and the items of expense that were considered to be reasonably attributable to the production of oil or gas from the well. The basic revenue item in the case of each well was, of course, the amount representing the oil or gas that was delivered by it to some other department of the appellant. Such oil was priced at the posted field price, that is to say, its current market value at the date of its delivery. The gas was priced at the same amount as would have been paid to outsiders who delivered gas to the appellant's processing plant. In other words, the value of the amount of the oil or gas delivered from the well was credited to it at the market price that was current at the date of its delivery in the same way as if it had sold the oil or gas to a third person. On the other side of the account, the well was charged with the various expenses that would have been chargeable to it if it had been the appellant's only producing well, including, of course, the expenses that were deductible under section 53 of the 1949 Act. It is obvious that the items of chargeable expense were not the same in the case of each well. Thus, for example, if a well was producing oil or gas for the whole 12 months of 1951, there would be no drilling costs charged against it, for no such costs were incurred in 1951. But, I should enumerate the various items of expense that appear in the accounts, although they do not all necessarily appear in each one. Thus, the amount of oil issued to a royalty holder was a proper expense item but, since he did not ordinarily accept the oil in kind, its market value was paid to him and this amount was charged as an expense. Then, in each case the values of the opening and closing inventories of the well were taken into account on the basis of their cost but these amounts were necessarily small since only one or two days' production from the well would be involved. The other items of expense chargeable to a producing well were either direct or indirect. I enumerate the

direct expenses as they were set out by Mr. McLellan. They included such items as drilling costs where such costs were incurred in 1951. Apart from such drilling costs directly related to the producing well, there were other items of direct deductible expense that were reasonably attributable to the production of oil or gas from the well. They included direct operating expenses, such as labor, materials, operations at the well site and expenses at the battery site, items consumed in the operation of various kinds, production losses, lease rental, surface rental, taxes, and depreciation of equipment at the well head, such as tanks, batteries, separators and the like. All of these items of direct expense were carefully explained by Mr. McLellan. There were also items of indirect expense. In this connection Mr. McLellan filed 12 charts as Exhibits 81 to 92. Of these, Exhibits 81 to 87 applied to Western Canada and the remainder to Eastern Canada. The charts showed the manner in which the various indirect expenses were distributed and charged to the wells. They dealt with such items as the distribution of the Toronto office administration and general expense, organization and accounting, distribution of district supervision and expense to individual oil and gas wells, distribution of Calgary office general costs to individual oil and gas wells, distribution of miscellaneous operating charges and credits to individual oil and gas wells, distribution of administrative and general expense to individual oil and gas wells, and the distribution of exploration overhead expense. The charts applicable to Eastern Canada, filed as Exhibits 88 to 92, were of a similar nature and I need not enumerate the items dealt with by them. The nature and the manner of distribution and allocation of the various kinds of indirect expense appear from the charts and were carefully explained by Mr. McLellan. The propriety and accuracy of the charges were not challenged, and I see no reason why I should not accept them. In addition to these items of indirect expense there were the charges of exploratory costs that were set out in Exhibits 48, 63 and 74 and explained in detail by Mr. Macgregor, Mr. Gibson and Mr. Roliff and confirmed by Mr. Vallat, to which further reference will be made later when the item of $19,992,588.33 of exploratory costs is considered. These were charged as items of expense to the wells to which they were shown to be related.

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I am confirmed in my acceptance of Mr. McLellan's conclusions by the opinions of Mr. McDonald and Mr. Richardson. Mr. McDonald agreed that the revenue stated by Mr. McLellan for each well was correctly determined and that the amount of the profits from the appellant's profitable producing wells, as set out in column 14 of Exhibit 77, and the amount of the losses from its loss producing wells, as set out in column 13 of the same exhibit, were correctly determined. I assume that his answer would have been the same in respect of columns 7 and 6 of Exhibit 78. Mr. McDonald also approved the allocations of indirect expense made by Mr. McLellan with one exception, which would have increased the appellant's profits.

And Mr. Richardson, subject to some qualifications in respect of which there was no evidence, agreed generally with Mr. McLellan's conclusions, subject to the same exception that Mr. McDonald had made. Thus, it may be taken for granted that Mr. McLellan's accounting was in accord with good accounting practice.

The total amounts of the profits from the profitable producing wells and of the losses of the loss producing wells are set out in detailed reconciliation statements prepared by Mr. McLellan and filed as Exhibits 77 and 78. These show the totals of the revenue items and expense items to which reference has been made and the net results. The total of the profits from the profitable producing wells came to $39,070,999.79, made up of $38,194,024.94 from Western Canada, as appears from column 14 of Exhibit 77, and $876,974.85 from Eastern Canada, as appears from column 7 of Exhibit 78. The total of the losses of the loss producing wells came to $8,066,012.55, made up of $8,007,237.16 from Western Canada, as appears from column 13 of Exhibit 77, and $58,775.39 from Eastern Canada, as appears from column 6 of Exhibit 78. The said totals appear on Exhibits 93 and 94 which were prepared by Mr. McLellan showing the results from the various oil fields.

There were refereneces in the evidence to shut-in oil wells and capped gas wells. The reason for capping gas wells was that the market for natural gas was not sufficient to justify its removal from all the gas wells that had been completed up to the end of 1951 and some of them had to be capped. And in the case of the shut-in oil wells the reason for shutting them in was that transportation facilities were not

available at the time. Under the circumstances, I have excluded from consideration the shut-in oil wells and the capped gas wells on the ground that although they were capable of production in 1951 if they had not been shut-in or capped there was not any actual production of oil or gas from any of them in 1951 and it could not be said that any profits or losses were attributable to the production of oil or gas from any of them. In my opinion, they should be eliminated from consideration in the computation of the base for the appellant's deductible allowance.

Thus, subject to consideration of the items of $19,992,-588.33 of exploratory costs and $8,642,196.84 of inventory adjustment to which I shall refer later, I find on the evidence that the profits of the appellant for 1951 that were reasonably attributable to the production of oil or gas from its profitable producing wells amounted in the aggregate to $39,070,999.79 and that its losses for 1951 that were reasonably attributable to the production of oil or gas from its loss producing wells amounted in the aggregate to $8,066,-012.55. The deduction of the aggregate of the losses from the aggregate of the profits left a net of $31,004,987.24. I find, pursuant to subsection (4) of section 1201 of the Regulations, that this was the amount of the appellant's profits for 1951 that were reasonably attributable to the production of oil or gas in 1951 from all the wells operated by it in that year.

It is apparent from this finding that I do not agree with the submission of counsel for the appellant that it is entitled to have its deductible allowance computed on the base of $39,070,999.79, being its profits for 1951 reasonably attributable to the production of oil or gas from its profitable producing wells in that year without deduction of the losses of its loss producing ones, on the ground that subsection (4) of section 1201 of the Regulations is *ultra vires* and severable from the rest of the section. The submission was that section 11(1)(*b*) of the Act did not authorize a regulation that was so inconsistent with subsection (1) of section 1201 of the Regulations as subsection (4) was, and that, since the base for the computation of the deductible allowance permitted by section 11(1)(*b*) of the Act was fixed by subsection (1) of section 1201 of the Regulations as the profits reasonably attributable to the production of oil and gas in the year, determined on an individual well basis, it was not

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permissible to change such base as subsection (4) did. In my opinion, the submission is unsound. The power to enact a regulation determining the amount of the deductible allowance permitted by section 11(1)(*b*) of the Act and the base for its computation was granted in the broadest terms and I cannot see any limitation of it such as counsel suggests. The section of the Act does not specify what the base for the computation of the allowance should be or its amount. Thus, it was permissible to fix the profits reasonably attributable to the production of oil or gas as the base for the computation of the allowance and 33⅓ per cent of such base as its amount, as subsection (1) did. But it was also permissible to define such profits for application in cases where a taxpayer operated more than one well and some of the wells were loss producing, even if such definition altered the base fixed by subsection (1), as subsection (4) did. It contains a statutory definition of the profits referred to in subsection (1) for use in the cases stated in it. I see no objection to such a definition for use in the circumstances specified. In my opinion, subsection (4) is within the authority of section 11(1)(*b*) of the Act. That being so, it is unnecessary to consider the question of its severability.

I now come to the question whether the Minister in determining the amount of the appellant's profits for 1951 "reasonably attributable" to the production of oil or gas from its wells had any right to charge against such production the amount of $19,992,588.33 for exploratory drilling and other costs which, according to the appellant, was not related to any of its production. In my opinion, as already stated, the ascertainment of the appellant's profits "reasonably attributable" to the production of oil or gas from its wells necessarily involves a computation of the expenditures reasonably attributable to such production as well as that of the receipts reasonably attributable to it. If an expenditure is to be chargeable against a well it must be shown that it was incurred in 1951 and was "reasonably attributable" to the production of oil or gas from such well in that year. Whether a particular expenditure was "reasonably attributable" to such production must, of necessity, be a question of fact and its determination must depend, largely at any rate, on the opinions of persons qualified to express

them. Mr. Macgregor, Mr. Gibson and Mr. Roliff were unquestionably such persons and a review of their evidence is, therefore, in order.

Mr. Macgregor stated that he had made a study of all the maps and the records of the appellant to satisfy himself what exploratory work done in 1951, if any, was related to any of its production of oil or gas in that year and he prepared a schedule of the only exploratory work in Western Canada that, in his opinion, was related to such production. This schedule, which was filed as Exhibit 48, shows that certain exploratory work was related to the production of oil or gas in 1951. The exhibit shows the nature of the exploratory work done, the portion of its relationship to a well, the well to which it was related and the status of the related well. The percentage of relationship of the work done to the production of the well was determined by Mr. Macgregor, who also determined the well to which the exploratory work was said to be related. Mr. Macgregor gave a detailed explanation of the various items set out in Exhibit 48 and his reason for his conclusion in each case. Most of the work referred to in the exhibit related to capped gas wells and I need not discuss it. But there were three and a half miles of seismic survey work in the west side of the Leduc field done in July of 1951 and there were late charges in respect of a velocity survey on Imperial Leduc 253, which Mr. Macgregor considered to be related to Imperial Leduc 394 and Imperial Leduc 395, both producing wells. The work resulted in the selection of the drilling sites for the two wells and Mr. Macgregor felt that its cost should be attributed to them in equal proportions of 50 per cent to each.

Mr. Macgregor was emphatic in his opinion that, apart from the exploratory work referred to in Exhibit 48, all the other exploratory work done in Western Canada in 1951 was not related to the production of oil or gas from any well in 1951. Thus, there was no relationship between any of the dry holes drilled in 1951 and the production of oil or gas in that year. Nor was there any such relationship in the case of such exploratory work as magnetometer, gravitymeter, photogeology and surface geology surveys. And there was no such relationship in the case of wells where the drilling was incomplete at the end of 1951, or in the case of any of the late charges incurred in 1951 in respect of wells drilled previously, except as set out in Exhibit 48.

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The evidence of Mr. Gibson was of a similar nature. He stated that he had made an examination of all the development work carried on by the appellant in Western Canada in 1951 with a view to determining what part of it related to production of oil and gas in that year. He had caused a list to be prepared of the wells drilled by the appellant in 1951. This was filed as Exhibit 60 and shows 289 oil wells, 2 gas wells and 12 dry holes. There was also a list, filed as Exhibit 61, showing the development preparatory costs incurred by the appellant in 1951 in respect of 77 wells that were incomplete at the end of the year and also 213 cases of late charges incurred by the appellant in 1951 in respect of wells drilled previously. There was a further list, filed as Exhibit 62, showing preparatory costs and late charges in respect of all wells including shut-in oil wells and capped gas wells. Mr. Gibson also prepared a schedule, filed as Exhibit 63, showing that certain development work, although resulting in dry holes, was related to the production of oil or gas in 1951. The exhibit shows, as Exhibit 48 did, the nature of the work, the portion of its relationship to a well, the well to which it was related and the status of the related well. Mr. Gibson gave a detailed explanation of the items set out in Exhibit 63 and his reason for his conclusion in each case. Thus, while Imperial Woodbend 15, one of the dry holes referred to in Exhibit 63, was an incomplete development dry hole, the information from it led to the selection of the site for Imperial Woodbend 78, a producing oil well, and Mr. Gibson felt that 25 per cent of the cost of the incomplete dry hole should be attributed to it. And there were late charges at development dry holes at Imperial Amelia 53 and Imperial Opal 35 in the course of which information was obtained that was related to the locations of Imperial Amelia 98 and Imperial Opal 43 respectively, both producing oil wells, and Mr. Gibson felt that a portion of such charges should be attributed to these wells and put the portions at 15 per cent and 10 per cent respectively.

Mr. Gibson was definite in his opinion, based on his examination of the appellant's records and his own knowledge of its development work in Western Canada in 1951, that the dry holes drilled by it in 1951 did not make any contribution to any of the appellant's production of oil and gas in 1951. And his answer was the same, subject to his references to the items set out in Exhibit 63, with regard to

dry holes that were incomplete at the end of the year and late charges in 1951 at development dry holes drilled previously.

Mr. Roliff also produced a summary, filed as Exhibit 74, which showed all the related exploratory work in 1951 in Eastern Canada which, in his opinion, contributed to the appellant's production of oil or gas in 1951 or to a shut-in well. This exhibit, like Exhibits 48 and 63, showed the nature of the related drilling and exploratory effort, the portion of its cost that was related, the well to which it was related and the status of the related well. Most of the items in Exhibit 74 relate to capped gas wells so that I need not refer to them. But there were two items that related to producing wells. There were late charges at a development dry hole at Imperial Becher 54 and Imperial Becher 57, both producing oil wells, and Mr. Roliff put the portions of such late charges that were attributable to them at 10 per cent and 5 per cent respectively. And there were late charges at Imperial Duthill 5 and 6, which were exploratory dry holes, that were related, in Mr. Roliff's opinion, to Imperial Duthill 7, a producing gas well, and he considered that 30 per cent of the charges were attributable to that well. The reasons for Mr. Roliff's attributions of these portions of costs were given in detail by him but it is sufficient to say, generally, that although the drilling resulted in dry holes some valuable information had been obtained in the course of the drilling that led to the location of a producing well. That was the justification for charging some of the cost of the unsuccessful work as an expense of the producing well to which the work was related.

Mr. Roliff stated that he had examined the records of the appellant as to its exploration and development work in 1951 in Eastern Canada with a view to determining whether it had any relationship to its production of oil or gas in 1951 or to the discovery of a shut-in oil well or a capped gas well and he was specific in his statement that Exhibit 74 contained a list of all the exploration work done and all the dry holes drilled in 1951 in Eastern Canada that had any relationship to any production of oil or gas by the appellant in 1951. It follows, of course, that, in his opinion, the cost of all the rest of the exploration work, other than that which resulted in a successful well, and of all the dry holes

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incurred in 1951 was not attributable to any of the appellant's production of oil or gas in that year.

The opinion of Mr. E. H. Vallat, an experienced oil consultant, confirmed the opinions of Mr. Macgregor, Mr. Gibson and Mr. Roliff, as respectively expressed in Exhibits 48, 63 and 74. He had examined these exhibits, had studied the appellant's records, examined the maps and considered the exploratory surveys and drillings and the development drillings. He agreed that in each case referred to in the exhibits the work done was related to the successful well referred to in the sense that some part of its cost was attributable to it. Only in one case would he have assigned a greater percentage of cost to the related well. In many of the cases he considered that the allotment of attributable percentage of cost had been too high and in the others he agreed with the author of the exhibit. Generally, therefore, he considered that the allotments of percentages, although some were on the high side and one was a bit low, were reasonable.

Thus I find as a fact that the exploratory costs referred to were not related to the production of oil or gas from any of the appellant's wells. They were not items of expense that could properly be charged against any producing well. Consequently, it could not be said that they were reasonably attributable to any production. They were not. The details of the exploratory dry hole drilling and other costs, and of the incomplete drilling, preparatory and other costs are set out in columns 11 and 12 of Exhibit 77 and columns 4 and 5 of Exhibit 78. They amount to $19,296,892.53 for Western Canada and $695,695.80 for Eastern Canada, making a total of $19,992,588.33. There is no dispute about the amount. In view of the evidence I conclude that the Minister had no right to deduct this amount or any portion of it from the amount of the appellant's profits as shown by the accounts of the wells in Exhibits 79a, 79b and 79c.

It is clear from this conclusion that I reject the contention of counsel for the respondent that subsection (5) of section 1201 of the Regulations requires the deduction of this amount. In my opinion, it does not. Counsel submitted that since the words "in respect of the well," which had appeared at the end of subsection (4) of section 1201, as it stood prior to its amendment, were omitted from subsection (5)

of the present section, which took its place, subsection (5) now requires the deduction of all the appellant's costs, exploratory and otherwise, that it deducted for income tax purposes under the authority of section 53 of the 1949 Act, regardless of whether they were related to the production of any oil or not. In my opinion, the argument is untenable. It does violence to the term "reasonably attributable" which is such an important feature of section 1201. This fact did not disturb counsel. Indeed, he submitted that the omission of the words eliminated the concept of "reasonably attributable" from section 1201. A construction that renders such terms meaningless is so unreasonable that it ought not to be accepted without clear and compelling terms. There are no such terms. The reason for the omission of the words is a simple one. The purpose of the amendment of section 1201 was to provide a base for the computation of the deductible allowance permitted by section 11(1)(*b*) of the Act that was reduced from that fixed by the section in its original form by the aggregate of the losses of the loss producing wells in cases where there were more than one well and some wells were operated at a loss. This was done by the enactment of subsection (4). That was the whole purpose of the amendment of section 1201 and the omission of the words "in respect of the well" from subsection (5) was merely a consequential amendment. Once subsection (4) was enacted the words had to be eliminated from subsection (5) in order to make it conform to the new subsection (4). Moreover, the construction put on subsection (5) by counsel for the respondent is inconsistent with the basic idea of section 1201 of the Regulations that the profits of a taxpayer for a year that are to be considered are those that are "reasonably attributable" to the production of oil or gas from the wells in that year, each well to be dealt with individually. How could it then be reasonably said that in computing the profits in a year from an individual producing well subsection (5) compelled the deduction of the total amount of expenditures that was deducted for income tax purposes under the authority of section 53 of the Act? If that was done in the case of one well the same deduction would have to be made in the case of every other well. In my opinion, subsection (5) does not contemplate such an absurdity. It is clear from the use of the words "amounts,

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if any" in the subsection that it was not contemplated that the total amount of the expenditures permitted to be deducted for income tax purposes by section 53 of the 1949 Act would have to be deducted in determining the base for the computation of the deductible allowance. If that had been intended, the word "amount" would have been used instead of the word "amounts". Moreover, the use of the words "if any" clearly indicates that there could be cases of individual wells where no deduction of any amount under section 53 of the Act would be required as, for example, in the case of wells operating for the whole of a year without any drilling costs having been incurred in it. Thus, the use of the words "amounts, if any" in subsection (5) negatives, as I have already stated, the contention put forward by counsel for the respondent. Moreover, it is a fundamental principle of construction that effect must be given to all the terms used. Thus, all the subsections of section 1201 of the Regulations must be read together so that full effect may be given to each. The contention of counsel for the respondent runs counter to this principle. For the reasons given, I have no hesitation in rejecting it.

Only one other subject remains for consideration, namely, whether the Minister, in determining the base for the computation of the appellant's deductible allowance, had any right to deduct the sum of $8,642,196.84, which is described in Exhibit 76 as "Increase (decrease) in unrealized profit in Supply, Manufacturing and Marketing inventories." Mr. McLellan explained that the amount represented the difference between the unrealized profit of the appellant's inventory at the beginning of the year and the unrealized profit of its inventory at the end of the year and that it relates solely to inventory that has passed away from the appellant's producing department to another department such as the manufacturing or marketing department. It does not include the amounts of the opening or closing inventories of oil or gas still in the hands of the producing wells for such amounts, necessarily small, have already been taken into account as shown by the accounts in Exhibits 79a, 79b and 79c.

It is important, in my opinion, to keep in mind that we are not here concerned with the manner in which the appellant's taxable income as a whole should be calculated. What

must be determined is the amount of the deductible allowance to which the appellant is entitled under section 11(1)(*b*) of the Act and section 1201 of the Regulations and this involves the ascertainment of the base for the computation of the allowance. Mr. Richardson was specific in stating that if each well was treated as a separate entity and he was asked to compute its profit he would not in computing it make any adjustment in respect of any inventory which had been moved from it to some other department of the appellant. I agree.

Here, I express the opinion that it is of the utmost importance in the present case to keep in mind the fact that the appellant is not engaged exclusively in the production of oil or gas but is what is called an integrated oil company, that is to say, it not only produces oil and gas but also engages in other activities, including the operation of refineries, the conduct of a marine oil transport service and the marketing of petroleum products. It seems elementary that this fact should not be allowed to operate to its prejudice. It should be entitled to the same deductible allowance under section 11(1)(*b*) of the Act and section 1201 of the Regulations as that to which it would have been entitled if it had been engaged only in the production of oil or gas, either from one well or several wells. In my opinion, such a result is possible in the appellant's case only if each well is dealt with individually and the amount of deductible allowance to which the appellant is entitled, if any, in respect of it is determined accordingly. That is why the accounts of each well were kept separately as shown by Exhibits 79a, 79b and 79c. On this basis of accounting, which I think was a proper one, the inventory adjustment of $8,642,196.84 was not warranted, for the inventory to which it relates had all moved out from the well to some other department as if it had been sold to it and was no longer in its hands. This was the opinion of the accountancy witnesses based on the assumption made. What happened to the inventory in the hands of the other departments and how it affected the computation of the appellant's taxable income as a whole is outside the scope of the present enquiry. Consequently, since the amount in question relates solely to inventory that has been delivered by the well to some other department in the same way as if it had been sold to a third person and is no longer in its hands, it should

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not be taken into account in determining the profits reasonably attributable to the production of oil or gas from such well. That amount must be determined separately in the case of each well as if it were a separate entity. Consequently, I find that the Minister had no right to deduct the amount of $8,642,196.84.

It follows from what I have said that the amount of the deductible allowance to which the appellant was entitled in 1951 under section 11(1)(*b*) of the Act and section 1201 of the Regulations is $10,334,995.74, being 33⅓ per cent of the base of $31,004,987.24 resulting pursuant to subsection (4) of section 1201. The Minister was, therefore, in error in allowing only $790,067.36 and the assessment appealed against must in respect of this item be set aside accordingly. The appeal will, therefore, be allowed with costs.

Judgment accordingly.

N.B.—The judgment herein was reversed by the Supreme Court of Canada [1960] S.C.R. 735. The Court, consisting of Chief Justice Kerwin and Taschereau, Locke, Cartwright, Martland, Judson and Ritchie, JJ., was unanimous in allowing the deduction of the inventory adjustment of $8,642,196.84 from the amount of the profits claimed by the taxpayer and in dismissing its counterclaim that its losses from its loss producing wells should not have been deducted. By a majority the Court also allowed the deduction of the drilling, exploration and other costs of $19,992,588.33, with Cartwright, Martland and Ritchie, JJ., dissenting, who would have dismissed the appeal so far as this item was concerned.