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*April 26
June 25

WILBERT L. FALCONER ..... APPELLANT;

AND

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

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Taxation—Income tax—Transfer of syndicate's interest in farmout agreement to company for share consideration—Allotment of shares to syndicate members—When right to shares arose—Valuation of shares—Whether income.

The appellant was one of a syndicate of four persons who, in May 1951, acquired a farmout agreement in respect of certain oil lands on which there was already a producing well. In order to spread the risk involved, 75 per cent of the farmout interest was sold. The syndicate members decided to form a company to take over the remaining quarter interest and, in consequence, Ponder Oils Ltd. was incorporated, as a private company, on June 15, 1951. The members agreed at that time that the consideration for the transfer of their rights under the farmout to Ponder should be 748,000 fully paid shares of the company, and of this number the appellant was to receive 166,000 shares. By a formal agreement of September 25, 1951, stated to be effective from June 15, 1951, the syndicate's interest in the farmout was transferred to Ponder in consideration of the issue of 748,000 fully paid shares.

*PRESENT: Locke, Cartwright, Abbott, Martland and Judson JJ.

The appellant was assessed on an additional $33,200 of income for 1951, on the basis that the Ponder shares which he received represented income in his hands for that year from an adventure in the nature of trade. This assessment was based on the proposition that the appellant did not acquire any right to his shares until after the successful completion of a second well on September 3, 1951, and at a time when, as a result of that successful completion the value of the Ponder shares had increased. The appellant's contention was that the agreement for the transfer of the farmout to Ponder for a share consideration was actually made before the drilling of the well had been commenced and that the shares to be received by the syndicate for the transfer, at that time, could have no value greater than the value of the actual asset which the syndicate was conveying to Ponder.

Appeals by the appellant to the Tax Appeal Board and the Exchequer Court were dismissed. An appeal was then brought to this Court.

Held (Abbott and Judson JJ. dissenting): The appeal should be allowed.

Per Locke, Cartwright and Martland JJ.: On June 15, 1951, by agreement among the syndicate members, possession of their asset passed to a private company, which had no other assets, pursuant to an undertaking that they would receive 748,000 of its shares. These shares at that time could have a value no more and no less than the value of the asset turned over to the company. No profit could, at that time, accrue to the appellant in respect of the 166,000 shares to which he was then entitled.

The agreement of September 25 did no more than to evidence, in writing, an agreement which already existed. Consequently, it was not proper to attribute as income to the appellant the value placed upon his shares as of September 25, 1951.

Per Abbott and Judson JJ., *dissenting*: It was not until the intention of the syndicate promoters was expressed in the formal agreement of September 25, 1951, that the appellant became entitled to receive the shares allotted to him. The shares were then worth substantially more than the appellant's interest in the syndicate on June 15, 1951. The result was that the appellant was properly assessed on the basis that the receipt by him as a syndicate member of the shares of Ponder was a receipt of income from a venture in the nature of trade.

Doughty v. Commissioner of Taxes, [1927] A.C. 327, referred to.

APPEAL from a judgment of Thurlow J. of the Exchequer Court of Canada[1], dismissing an appeal from a decision of the Tax Appeal Board. Appeal allowed, Abbott and Judson JJ. dissenting.

J. H. Laycraft, for the appellant.

M. Bancroft and *G. W. Ainslie*, for the respondent.

The judgment of Locke, Cartwright and Martland JJ. was delivered by

MARTLAND J.:—In the year 1951 the appellant, along with three other persons, decided to acquire from Imperial Oil Limited (hereinafter called "Imperial") a farmout in

[1] [1961] Ex. C.R. 353, [1961] C.T.C. 306, 61 D.T.C. 1176.

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respect of certain lands, the subject-matter of a petroleum and natural gas lease held by Imperial as lessee. The farm-out was granted by Imperial by an agreement, in writing, dated May 25, 1951, to one of the members of the syndicate, Paul Moseson, who acted as representative for the group. There was already, at that time, a producing well on the lands. The agreement required the payment to Imperial of $40,000. Moseson undertook certain drilling commitments on the land. There was also provision for the delivery of specified quantities of any oil produced from any wells which were so drilled.

In order to spread the risk involved, agreements were made by Moseson with two companies, Central Explorers Limited (hereinafter called "Central") and Banff Oil Limited (hereinafter called "Banff"), whereby, in consideration of $30,000 paid by the former and $15,000 paid by the latter, together with their agreements to contribute toward the drilling costs involved in the drilling of the wells pursuant to the farmout, these two companies acquired between them a 75 per cent interest in the producing well and specified percentage interests in the wells subsequently to be drilled, toward the cost of which they were required to contribute.

The members of the syndicate agreed to incorporate a company to take over their interests under the farmout and, in consequence, Ponder Oils Ltd. (hereinafter called "Ponder") was incorporated, as a private company, on June 15, 1951, with an authorized capital consisting of 1,000,000 shares without nominal or par value. Out of the funds obtained as a result of the agreements with Central and Banff, $40,000 was paid to Imperial pursuant to the farmout agreement. The remaining $5,000 was placed in a special trust account and, subsequent to its incorporation, was turned over to Ponder.

Pursuant to the agreement with Imperial, production from the producing well on the property began to accrue for the benefit of the syndicate on May 26, 1951. The moneys thus received were also held in the same trust account which, after its incorporation, became the bank account of Ponder.

The drilling of a well on the lands, the subject-matter of the farmout, was commenced by Ponder on July 27, 1951. Drilling proceeded and calls were made from time to time

upon Central and Banff for their contributions toward the drilling costs. The well was completed on September 3, 1951, and proved to be a successful producer of oil.

Ponder had been incorporated at the instance of the four members of the syndicate, who were the only persons beneficially interested in it until after the completion of the well. Until August 23, 1951, its directors were Moseson, the company's solicitor, and the solicitor's secretary. On that date the latter was replaced on the board of directors by the appellant.

The members of the syndicate had agreed, at the time Ponder was incorporated, as to the amount of their share interest in the company, to be received as consideration for the transfer to Ponder of all their rights under the farmout agreement. It had been agreed that 748,000 shares should be issued, fully paid, of which Moseson should receive 250,000 and each of the other three members 166,000. Moseson agreed to convey to Ponder certain other properties in which he, alone, was interested.

The formal documentation of some of these transactions lagged substantially behind the actual events. For example, although the payment of $15,000 had been promptly made by Banff and it had contributed its share of the cost of drilling the well, the written contract evidencing its interest was not actually executed until October 2, 1951. Similarly, the written agreement to evidence the transfer by Moseson to Ponder of the interest of the syndicate in the farmout agreement was not executed until September 25, 1951. That agreement recited the payment which had been made by Moseson to Ponder of the sum of $5,000. It provided for the issue of 748,000 fully paid shares of Ponder to Moseson and his nominees.

It was provided in this agreement that: "This Indenture shall be effective as and from the 15th day of June, 1951, as if the same had been executed and delivered on that date."

On the same date a written agreement was executed by the four members of the syndicate, whereby Moseson agreed to cause the shares to be issued and allotted by Ponder as to 250,000 shares to himself and 166,000 shares to each of the other three members of the syndicate, who, in turn,

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agreed to accept such shares in full satisfaction of any claims and demands which they might have against Moseson in respect of the properties.

Subsequent to the execution of these agreements, shares were allotted. Up to the time of the trial, the appellant had not disposed of any of his 166,000 shares.

Before these written agreements had been executed, Ponder had issued and allotted 251,997 of its shares at a price of 40 cents cash per share. Subsequent to that issue, on September 12, 1951, Ponder had been converted into a public company and its share capital had been increased by the creation of an additional 3,000,000 shares without nominal or par value.

The appellant has been assessed for income tax for the year 1951 on an additional $33,200 of income for that year, on the basis that the 166,000 shares of the capital stock of Ponder which he received represent income in his hands for that year from an adventure in the nature of trade. In determining this figure, the shares were valued at 20 cents each by a comparison with the price paid of 40 cents per share for the 251,997 shares issued in September, subject to a 50 per cent discount owing to the fact that the shares received by the appellant were subject to an escrow agreement.

This assessment is based on the proposition that the appellant did not acquire any right to his 166,000 shares until after the successful completion of the well on September 3, 1951, and at a time when, as a result of that successful completion, the value of Ponder's shares had increased.

The appellant's contention is that the agreement for the transfer of the farmout to Ponder for a share consideration was actually made before the drilling of the well had been commenced and that the shares to be received by the syndicate for the transfer, at that time, could have had no value greater than the value of the actual asset which the syndicate was conveying to Ponder. He relies on the authority of *Doughty v. Commissioner of Taxes*[1].

[1] [1927] A.C. 327.

At p. 336, Lord Phillimore, who delivered the judgment of the Privy Council, said:

The other ground on which the appellant's case may rest is that the transaction which led to the claim for tax was not a sale whereby any profit accrued to the two partners. The case of Craig (Kilmarnock) (1914 S.C. 338) just referred to is an authority for saying that the Crown is not entitled to take a mere bookkeeping entry as conclusive evidence of the existence of a profit. The two partners made no money by the mere process of having their stock in trade valued at a high rate when they transferred to a company consisting of their two selves.

If they overestimated the value of the stock the value of the several shares became less. The capital of the company would be to this extent watered. As already observed, they could not, by overestimating the value of the assets, make them more.

The appellant's appeal to the Tax Appeal Board was dismissed and his appeal from that decision was, in turn, dismissed by the Exchequer Court[1]. The basis of the decision in that Court is contained in the following extract from the reasons for judgment:

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

[1] [1961] Ex. C.R. 353, [1961] C.T.C. 306, 61 D.T.C. 1176.

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suggestive that the consideration was to be something else and probably shares, there was still no promise by the company to pay in shares to the exclusion of any other kind of payment. In my view, the syndicate's right to be paid by Ponder in shares arose for the first time on September 25, when their right to payment for what Ponder had acquired from them was converted from a right to be paid in some form to a definite right to shares.

There is, in this passage, at the very outset, a finding of fact that, from the inception of Ponder or shortly afterwards, that company obtained possession of the assets and rights of the syndicate and discharged the syndicate's obligations under the farmout agreement. This finding is, in my opinion, of great importance. Ponder had, with the consent of the members of the syndicate, taken over possession of the syndicate's asset, the farmout agreement, and, in turn, Ponder received the production from the completed well on the farmout property from and after May 26, 1951. The acquisition of that possession must have been by virtue of some agreement with the syndicate and, that being so, if the syndicate had sought against Ponder a direction for specific performance, the principle stated by Turner L.J. in *Wilson v. West Hartlepool Railway Company*[1], adopted by Kay J. in *Howard v. Patent Ivory Manufacturing Company*[2], would be applicable:

> Where possession has been given upon the faith of an agreement, it is I think the duty of the Court, as far as it is possible to do so, to ascertain the terms of the agreement and to give effect to it.

What were the terms of the agreement by virtue of which Ponder had become possessed of the assets of the syndicate? It is clear, on the evidence, that all members of the syndicate understood that there would be an issue of fully paid shares by Ponder to the syndicate members in consideration for the asset. The four members of the syndicate had agreed upon that consideration. They were the sole beneficial owners of Ponder, which, at that time, had issued only three qualifying shares, which were subject to the control of the syndicate members. One of the members of the syndicate, Moseson, was a director of Ponder and the other two directors were his nominees. This being so, it appears to me that when Ponder took possession of the asset the

[1] (1865), 2 De G. J. & Sm. 475 at 494.
[2] (1888), 38 Ch. D. 156 at 163.

consideration which it was to pay had been agreed upon by everyone who was in a position to determine the intent of that company as to the consideration which it should pay. In my view, had he desired so to do, the appellant was in a position, once Moseson had turned over to Ponder possession of the syndicate assets in which he had an interest, to compel Moseson, as his trustee, to take the steps necessary to obtain the issuance to him of his 166,000 shares in the capital stock of Ponder.

That there was an agreement in existence before the execution of the written agreement between Moseson and Ponder on September 25 is recognized specifically in that document, in the clause which has been quoted earlier.

The reason why there had not been a written agreement at an earlier date is explained by the appellant in his evidence:

BY MR. LAYCRAFT:

.....

Q. That document is dated September 25, 1951. When was the arrangement made? A. The arrangement was made in May, 1951.

Q. Was the arrangement in fact carried out from the incorporation of Ponder Oils Limited? A. It was.

Q. Why then is the document dated so much later? A. Mainly because Ponder Oils had no personnel to press on to get the documentation up-to-date until after the 1st of September, and they got this out as quickly as possible.

Q. Do you continue to blame lawyers—

BY HIS LORDSHIP:

Q. The arrangement was made in May, 1951, but it was in fact carried out from the time of incorporation? A. Yes, Your Lordship.

Q. You said something else. It is dated later because Ponder Oils had not—what? A. They had no one to press on with the documentation or arrangements that had been made until after the 1st of September.

BY MR. LAYCRAFT:

Q. Do you continue to blame lawyers? A. Yes.

The position is, therefore, that by agreement among the syndicate members, possession of their asset passed to a private company, which had no other assets, pursuant to an understanding that they would receive 748,000 of its shares, fully paid, of which the appellant should receive 166,000. At that time Ponder had no issued shares other than the three qualifying shares held by its first directors. The 748,000 shares agreed to be issued to the syndicate

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members at that time could have a value no more and no less than the value of the asset which had been turned over to it. No profit could, at that time, accrue to the appellant in respect of the 166,000 shares to which he was then entitled.

In my opinion, the agreements of September 25 did no more than to evidence, in writing, agreements which already existed and, consequently, it is not proper to attribute as income to the appellant the value placed upon his 166,000 shares as of September 25.

In my opinion, the appeal should be allowed, with costs both in this Court and in the Exchequer Court, and the reassessment, dated December 17, 1956, as varied by the Minister, should be vacated.

The judgment of Abbott and Judson JJ. was delivered by

JUDSON J. (*dissenting*):—The appellant is one of a syndicate of four persons who, in May of 1951, acquired a farmout agreement from Imperial Oil Limited. On June 15, 1951, the syndicate caused to be incorporated Ponder Oils Limited for the purpose of transferring to that company the asset to be exploited. The question at issue in this appeal is whether the company was bound by agreement to issue shares for the asset on June 15, 1951, or whether that obligation arose for the first time on September 25, 1951. The importance of the date is that in the interval the property had proved to be valuable and Falconer had made a substantial profit as a member of the syndicate.

The Exchequer Court, after a careful and detailed review of the dealings among the syndicate members and between them and the company, concluded that there was no agreement for the issue of shares until September 25, 1951, and that consequently, tax was payable.

The syndicate acquired the farmout agreement by an agreement in writing dated May 25, 1951. There was probably a prior oral agreement because on May 17, 1951, it sold a half interest in the farmout agreement for $30,000. By an agreement in writing dated October 2, 1951, the syndicate also sold a quarter interest for $15,000. This $15,000 was paid by the purchaser of the quarter interest long before the formal date of the agreement. I say this

because as a result of the two sales comprising the three-quarter interest, the syndicate received $45,000 in cash, of which it paid $40,000 to Imperial Oil. This $40,000 was the purchase price under the farmout agreement. These two purchasers of the half interest and quarter interest respectively agreed to contribute to the drilling costs in the proportions of their interest.

On June 15, 1951, Ponder Oils Limited came into being as a private company with an authorized capital stock of one million shares n.p.v. Drilling began in July of 1951 and by September 3, 1951, there was a well in production. On September 12, 1951, Ponder Oils Limited was converted into a public company and its authorized capital was increased by the creation of an additional three million shares n.p.v. Shortly before this happened, the company had sold 251,997 shares privately at 40 cents per share. In addition, there were three qualifying shares outstanding.

The next step was the execution of the formal agreement between Paul Moseson, the syndicate manager, and Ponder Oils Limited. It was dated September 25, 1951, and it provided that it should be effective from June 15, 1951, as if it had been executed and delivered on that date. It recites the following facts:

(a) The acquisition of the farmout agreement from Imperial Oil Limited by agreement dated May 25, 1951.

(b) The sale of the half interest by agreement dated May 17, 1951.

(c) The agreement to sell the quarter interest. (This is the agreement which was not put in writing until October 2, 1951.)

(d) The existence of a lease known as the Berube lease held by Moseson and at that time the subject-matter of litigation in the Supreme Court of Alberta.

(e) Moseson's holding of four units in the Kavanagh Oil syndicate.

Moseson then transfers to the company the remaining one-quarter interest in the Imperial farmout agreement in consideration of the issue of 748,000 fully paid shares n.p.v. The company also acknowledges receipt of $5,000 from Moseson. This is the balance of $5,000 remaining from the

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proceeds of the sale of the half interest and the quarter interest. This money appears to have been turned over to Ponder immediately on its receipt.

Moseson agrees to prosecute the action to establish the Berube lease and to assign it to the company if the action is successful. Moseson also transfers his interest in the Kavanagh certificate, Ponder to assume Moseson's liability of $1,000 in respect of this.

In addition to issuing the shares, Ponder agrees to indemnify Moseson against all his liabilities under the Imperial farmout agreement, also to indemnify him if the purchaser of the quarter interest took a certain course of action.

This is obviously an elaborate agreement defining the relations between the syndicate and the company. The 748,000 shares were issued in escrow and were divided as follows:

P. E. Moseson	250,000 shares
W. L. Falconer	166,000 shares
T. A. Link	166,000 shares
A. W. Nauss	166,000 shares

Moseson received 84,000 more shares than each of the others because he alone was interested in the Berube lease and the Kavanagh syndicate. As stated above, the problem is whether the appellant Falconer realized a profit on September 25, 1951, from the receipt of these shares.

The findings of the learned trial judge are as follows:

> In my view, the syndicate's right to be paid by Ponder in shares arose for the first time on September 25, when their right to payment for what Ponder had acquired from them was converted from a right to be paid in some form to a definite right to shares.
>
> The material fact, in my opinion, is that through carrying out their scheme, the syndicate became entitled to shares on September 25, but not until then, and thereby realized profit from their scheme in the form of a right to shares. September 25, in my opinion, is accordingly the date at which the right to the shares to which the appellant became entitled should be valued.

In addition, the evidence shows, although not very clearly, that it was Ponder that actually conducted the drilling operations. How Ponder was financed during this interval to enable it to operate does not appear. The evidence also seems to show that from the moment of the acquisition of the property the syndicate members intended

to incorporate Ponder and to turn over the property to the company for a certain number of shares. I am not satisfied on the evidence that the Berube lease and the Kavanagh syndicate interest were ever intended to be included in the deal until the written agreement came to be executed.

But these were merely the intentions of the promoters. No corporate action whatever was taken along these lines until September 25, 1951. There were no meetings of directors to approve of any agreement with the syndicate. The company appears to have done nothing in a corporate way beyond holding the formal meetings to get itself organized. It did not agree to issue any shares. It received no transfer of the farmout agreement. It did receive the $5,000 from Moseson and it did spend money for the development of the property. It seems to me quite impossible to hold that on June 15, 1951, there was a contract between the company and the syndicate for the transfer of these property interests mentioned in the agreement of September 25 in consideration of the allotment by the company of the 748,000 shares. Until the date of the formal agreement everything depended upon the intention of the syndicate promoters. Neither party could, on June 15, 1951, have proved the existence of a concluded contract on these terms and an action for specific performance by either party to enforce such terms would have failed. This contract is a bilateral matter. What the promoters intended to do when they had time to attend to the business does not establish a contract. The position between the two dates is that the company was apparently in possession of the property, developing the property at its own expense on the money from some unknown source. It is possible that the company might have established a right to acquire the property on payment of a reasonable price, although I am doubtful of that, but I am in complete agreement with the finding of the learned trial judge that it was not until September 25, 1951, that the company came under any obligation to issue a defined number of shares for the property, including the Berube lease and the Kavanagh syndicate interest. The appellant's right to receive the shares thus arose for the first time on September 25, 1951. The shares were then worth substantially more than the appellant's interest in the syndicate on June 15, 1951. The result is that the appellant was properly assessed on the basis that the receipt by him as a syndicate member

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of the shares of Ponder was a receipt of income from a venture in the nature of trade. The case is not within the principle of *Doughty v. Commissioner of Taxes*[1].

The remaining question is whether the shares were properly valued for the purpose of computing the tax. After reviewing the evidence of dealings in the shares and after discounting the value of these shares because they were subject to escrow, the learned trial judge affirmed the Minister's valuation at 20 cents per share. I can find no reason for disturbing this assessment.

I would dismiss the appeal with costs.

Appeal allowed, ABBOTT *and* JUDSON JJ. *dissenting.*

Solicitors for the appellant: Chambers, Might, Saucier, Peacock, Jones, Black & Gain, Calgary.

Solicitor for the respondent: E. S. MacLatchy, Ottawa.