1966

*Nov. 17,
Nov. 25

THE MINISTER OF NATIONAL REVENUE ..... APPELLANT;

AND

GEORGE H. STEER ..... RESPONDENT.

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Taxation—Income tax—Amount paid by taxpayer as guarantor of bank loan—Whether capital loss or deductible expense—Income Tax Act, R.S.C. 1952, c. 148, ss. 3, 4, 12(1)(a), (b).

In 1951, the appellant and an associate entered into an agreement with two other persons to acquire an interest in an oil company. The other two persons had obtained a farmout agreement from Imperial Oil Ltd., which they had assigned to the company for 1,000 shares and a royalty. Four wells were to be drilled, and when the agreement with the appellant and his associate was made, three wells remained to be drilled and financed. Pursuant to the agreement, the shares were divided so that each of the four associates held a quarter interest, and the royalty was similarly divided. In return, the appellant and his associate agreed to guarantee the company's indebtedness to the bank up to a maximum of $62,500 each. The consideration received by the appellant (the shares and the royalty) was taxed in 1951 as income and valued by the Minister at $4,500.

In 1957, the appellant had to pay $62,500 to the bank in discharge of his guarantee. He subsequently recovered as a creditor of the company's bankruptcy $6,119 in 1959 and $3,200 in 1961. The appellant sought to deduct his $62,500 loss from his income. The Minister refused to allow the deduction. The Exchequer Court reversed the decision of the Income Tax Appeal Board and allowed the deduction. The Minister appealed to this Court.

Held: The appeal should be allowed.

*PRESENT: Cartwright, Abbott, Judson, Ritchie and Hall JJ.

The transaction entered into by the appellant was a deferred loan to the company, part of which was recovered in the bankruptcy. The loss suffered by the appellant was a loss of capital, the deduction of which was prohibited by s. 12(1)(*b*) of the *Income Tax Act*.

Revenu—Impôt sur le revenu—Montant payé par contribuable en garantie d'un emprunt de banque—Perte de capital ou dépense déductible—Loi de l'Impôt sur le Revenu, S.R.C. 1952, c. 148, arts. 3, 4, 12(1)(a), (b).

En 1951, l'appelant et un associé ont passé un contrat avec deux autres personnes pour acquérir un intérêt dans une compagnie pétrolifère. Les deux autres personnes avaient obtenu de l'Imperial Oil Ltd. le droit d'explorer un certain terrain. Elles avaient assigné ce droit à la compagnie en question sur réception de 1,000 actions du capital ainsi que des redevances. Quatre puits devaient être creusés, et lorsque l'entente avec l'appelant et son associé est survenue, il restait encore trois puits à creuser et à financer. En vertu de l'entente, les actions furent divisées de telle sorte que chacun des quatre associés en obtint le quart, et les redevances furent divisées pareillement. En retour, l'appelant et son associé ont convenu de se porter garants de la dette de la compagnie à la banque jusqu'à un maximum de $62,500 chacun. La considération reçue par l'appelant (les actions et les redevances) a été frappée d'un impôt en 1951 et évaluée par le Ministre à la somme de $4,500.

En 1957, l'appelant a dû payer $62,500 à la banque en acquittement de sa garantie. Il a subséquemment recouvré comme créancier de la compagnie alors en faillite une somme de $6,119 en 1959 et de $3,200 en 1961. L'appelant a cherché à déduire de son revenu la perte de $62,500. Le Ministre a refusé de permettre la déduction. La Cour de l'Échiquier a renversé la décision de la Commission de l'Impôt sur le Revenu et a permis la déduction. Le Ministre en a appelé devant cette Cour.

Arrêt: L'appel doit être maintenu.

L'appelant a fait un prêt différé à la compagnie, et une partie de ce prêt a été recouvrée de la faillite. La perte subie par l'appelant était une perte de capital dont la déduction du revenu était prohibée par l'art. 12(1)(*b*) de la Loi de l'*Impôt sur le Revenu*.

APPEL d'un jugement du Juge Noël de la Cour de l'Échiquier[1], renversant une décision de la Commission de l'Impôt sur le Revenu. Appel maintenu.

APPEAL from a judgment of Noël J. of the Exchequer Court of Canada[1], reversing a decision of the Income Tax Appeal Board. Appeal allowed.

[1] [1965] 2 Ex. C.R. 458, [1965] C.T.C. 181, 65 D.T.C. 5115.

1966

MINISTER OF NATIONAL REVENUE v. STEER

D. S. Maxwell, Q.C., and *D. G. H. Bowman,* for the appellant.

H. Heward Stikeman, Q.C., and *P. N. Thorsteinsson,* for the respondent.

The judgment of the Court was delivered by

JUDSON J.:—This is an appeal by the Minister of National Revenue from the judgment of the Exchequer Court[1] which allowed an appeal from the decision of the Tax Appeal Board. This decision had rejected the taxpayer's contention that he was entitled in computing his income for the year 1957 to deduct a sum of $62,500 paid by him to the Dominion Bank under a guarantee of the indebtedness of Locksley Petroleums Limited signed in 1951. My opinion is that the appeal should be allowed and that the decision of the Board confirming the Minister's assessment should be restored.

In February 1951, the respondent and R. M. Montague made an agreement with William Buechner and Sam Yeske to acquire an interest in a company known as Locksley Petroleums Limited. Buechner and Yeske had obtained a farmout agreement from Imperial Oil on a quarter section of land in Alberta. This they assigned to the Locksley company in return for 1,000 shares and a two and a half per cent gross royalty. They or the company were obligated to drill four wells on the property. In February 1951, when they made their agreement with the respondent and R. M. Montague, his associate, three wells remained to be drilled and financed.

The agreement is simple. The shares were divided so that each associate held a quarter interest and the gross royalty was similarly divided. The respondent and Montague also each received three-quarters of one Net Royalty Trust Unit. In return they agreed to guarantee the company's indebtedness to the Dominion Bank up to the sum of $125,000, the liability of each guarantor being limited to the sum of $62,500. The respondent and Montague also stipulated that the company should assign to the bank the lease which it held on the property as security for the money to be borrowed by the bank and the liability of the guarantors. The total consideration which the respondent

1 [1965] 2 Ex. C.R. 458, [1965] C.T.C. 181, 65 D.T.C. 5115.

received for becoming liable on a guarantee for $62,500 was 250 shares in the company, one-quarter of the gross royalty of two and one-half per cent and three-quarters of one Net Royalty Trust Unit. This consideration was treated as income on a valuation of $4,500 by the Minister of National Revenue and taxed accordingly.

I have no difficulty in defining the character of this transaction. The company needed money for the drilling of three wells. The convenient way of supplying this money was by a bank loan with the respondent's guarantee to the extent of $62,500. The guarantee meant that at some time the respondent might have to step into the bank's shoes to this extent. This happened in 1957. He was then subrogated to the bank's position. He subsequently proved as a creditor in the company's bankruptcy and received two dividends—one in 1959 for $6,119 and the other in 1961 for $3,200. The transaction was a deferred loan to the company, part of which was recovered in the bankruptcy. These bankruptcy dividends, contrary to the *obiter dictum* in the judgment of the Exchequer Court, were not income but a partial recovery of a capital loss. They are in no way analogous to the consideration received in 1951 as the respondent's remuneration for the guarantee, which I have characterized as a deferred loan.

It is enough therefore to decide this case to say that in my opinion the loss here is a loss of capital and that its deduction is prohibited by s. 12(1)(*b*) of the Act.

I would allow the appeal with costs here and in the Exchequer Court and restore the assessment appealed from.

Appeal allowed with costs.

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

Solicitors for the respondent: Stikeman & Elliott, Montreal.