1955

IN THE MATTER OF the Income Tax Act and IN THE MATTER OF the Income Tax Amendment Act, 1949.

*May 24
*Oct. 4

HOME OIL COMPANY LIMITED .....APPELLANT;

AND

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

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Assessment—Taxation—Income Tax—Allowance deductible in respect of an oil or gas well in computing income—The Income Tax Act, 1948 (Can.) c. 52, s. 11(1)(b)—Income Tax Regulation No. 1201(1), (4)—Income Tax Amendment Act, 1949 (Can.) 2nd Sess. c. 25, s. 53.

The appellant is a corporation whose principal business is the production of petroleum and the exploring and drilling for oil or natural gas within the meaning of s. 53 of the *Income Tax Amendment Act*, (1949 Can. 2nd Sess. c. 25). In computing income for the years 1949 and 1950 for the purpose of calculating depletion allowance under s. 11(1)(*b*) of the *Income Tax Act* and Regulation No. 1201 of the Income Tax Regulations and s. 53 of the *Income Tax Amendment Act*, it deducted exploration, development and other expenditures incurred in respect of wells that had shown a profit on an individual well basis excluding similar expenditures incurred on wells operated at a loss. The respondent ruled that the latter expenditures, as well as the former, should be deducted but on an aggregate well basis.

Held: That the deductions are to be related to the wells individually and that unless the items of expenditure under s. 53 are clearly related to a profit producing well, they are not to be taken into account in determining the allowance under Regulation No. 1201 in respect of that well. Appeal allowed and the matter remitted to the Minister for re-assessment on the basis indicated.

Decision of the Exchequer Court [1954] Ex. C.R. 622 reversed.

APPEAL from a judgment of the Exchequer Court, Thorson P., (1) dismissing an appeal from the Income Tax Appeal Board.

R. B. Law, Q.C. and *S. H. S. Hughes, Q.C.* for the appellant.

Joseph Singer, Q.C. and *J. D. C. Boland* for the respondent.

*PRESENT: Rand, Kellock, Estey, Locke and Cartwright JJ.

(1) [1954] Ex. C.R. 622.

1955

HOME OIL COMPANY LTD. v. MINISTER OF NATIONAL REVENUE

The judgment of the Court was delivered by:—

RAND J.:—This is an appeal by a company engaged in the production of natural oil and gas, and the question raised is whether the income in respect of which the allowance for depletion under s. 11(1)(*b*) of *The Income Tax Act* as defined by Regulation No. 1201(1) and (4) is calculated, is or is not to be reduced by the total allowance authorized by s. 53 of 13 Geo. VI, c. 25.

S. 11(1)(*b*) reads:—

> (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,

S-ss. (1) and (4) of Regulation No. 1201 provide that:—

> (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 taxation 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.
>
> * * *
>
> (4) 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 from income under the provisions of section 53 of chapter 25 of the Statutes of 1949, Second Session, in respect of the well.

S. 53 is as follows:—

> (1) A corporation whose principal business is the production, refining or marketing of petroleum of petroleum products or the exploring and drilling for oil 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, on 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 aggregate of outgoings under s. 53(*a*) was the amount deductible in this case; and in determining the allowance under Regulation No. 1201 the Minister held that from the total income of the company arising from the oil production that aggregate amount should first be deducted. In this view "profits . . . reasonably attributable to the production of oil or gas from the well" mean the total income from all the wells operated less the total aggregate outlay related to oil in addition to the purely operating costs. That aggregate here is made up of costs of exploration and drilling, and general administrative expenses referable to those two items.

Mr. Nolan's contention is that the expression "profits of the well" requires a separate ascertainment for each profitable well: that drilling which does not win oil does not produce a "well"; and that only operating expenses plus, by virtue of s. 53, exploration and development costs related directly to each producing well with their appropriate share of general administrative costs are to be deducted from the proceeds of that well to determine its profit as the datum for the purpose of the allowance. On the other hand, Mr. Riley's position is that the word "well", by force of the Interpretation Act, is to be taken as including "wells" where more than one are operated, and that so taken, the profits from the wells, for the purposes of the allowance, and given the operation of s. 53 and s-s. (4) of the regulation, are the total income less total outlays as mentioned.

The claim of the Crown reduces itself here to a deduction from total oil income of three items, (*a*) exploration and drilling expenditures other than those directly related to the company's producing wells, (*b*) general and administrative expenses allocated to that exploration and development, and (*c*) operating deficits on individual wells. Both the Income Tax Appeal Board and the President of the Exchequer Court have upheld the Minister's contention, and the question is whether they are right.

The immediate consideration is that of Regulation No. 1201(1). The use of the word "profits" and of the expression "from the well" is, in the general context of the Act, singular, and to me they bear a signification that differentiates them from both "income" and "wells" or "oil". A company may operate only one well or a single well may be

1955

HOME OIL COMPANY LTD. v. MINISTER OF NATIONAL REVENUE

Rand J.

the subject of a lease from a land owner and many leases from any number of land owners may be operated by one company. Certainly the partitioned allowances to the lessor and lessee under s. 11(3) must be related to the profits strictly of at least the wells of the lessor: otherwise a lessee by large scale exploration costs in Nova Scotia might wipe out the "profits" on which a substantial allowance would otherwise be made to a lessor in Alberta. I am not in doubt, therefore, that the "profits" of a "well" are not intended to be identical in the sense claimed with the income of a company from its total oil operations remaining after the deduction of the allowance under s. 53 of amounts expended for capital work carried on anywhere in Canada. It remains to be seen in what they differ.

S-s. (4) of the regulation speaks of a deduction equal to that made from income under s. 53 "in respect of the well" from the profits "reasonably attributable to the production of oil or gas for the purpose of this section (1201)". I take this to imply that the outlays charged against the income under s. 53 must be "reasonably attributable" to the wells that have produced the profit and that means specially or directly related to them. On the argument of the Crown every outlay of every nature and wherever made in Canada, other than direct operating costs, must be taken as contributing to the income from the wells operating at a profit which produce it, and, for the purposes of the regulation, as attributed to those wells and as having been, under s. 53, deducted "in respect of" them. The allowance under s. 53 is an overall allowance related to total income for a specific purpose; the ascertainment of profits for the purposes of Regulation No. 1201 is on the basis of reasonable relation to the source of income and for a different purpose; and I am unable to agree that the total allowance under s. 53 can be said to be made "in respect of" the profitable wells. It might be that a dry hole is so related to a producing well that its cost, in one sense wasted, could be said to be incurred "in respect of" a profitable second well; that would be a question to be determined on geological and mining engineering considerations. But the costs of a dry hole, say, in Township 2 in Alberta could not, in any fair sense of the words, be related to a producing well in Township 20, and much less so to such a well in another province.

The difficulties in an attribution based on such matters are obvious. The anomalies in its application to lessors and lessees have been indicated: lessors would be deprived of their increment of wasting asset, though that asset produced the return that paid the general outlay, through means unrelated to their leases and over which they have no control. A dry hole on sec. 4 owned by A might be related geologically to a producing well on sec. 5 owned by B and to make that deduction for the purposes of a depletion allowance to B might deny depletion to him, while another producing well in A's land would be free of any such relation. That this allowance is made to offset the wasting capital resource is clear from the language of s. 12(*b*) which speaks of "depreciation, obsolescence or depletion", and if its purpose is not to be defeated, the producing wells must be dealt with individually.

Unless, then, the items of expenditure under s. 53 are clearly related to a profitable producing well, they are not to be taken into account in determining the allowance under Regulation No. 1201 in respect of that well. The purpose of enacting s. 53 was to promote exploration and development on the widest scale throughout the country, but I cannot take it as intending an effect that might wipe out what otherwise would be allowed to third persons under s. 11(3). The same considerations apply to wells that are operating at a loss; they represent drilling costs under s. 53 that cannot fairly be said to be "in respect of" profitable wells: no depletion can accrue in relation to them because they do not represent a productive value: but on the contention made, the total loss connected with them can be applied to deny depletion to profitable wells and to third persons interested in them.

I would, therefore, allow the appeal and remit the matter back to the Minister for a re-assessment of the taxes for the years 1949 and 1950 on the basis indicated. The appellant will have its costs in both courts.

Appeal allowed with costs.

Solicitors for the appellant: *Nolan, Chambers, Might, Saucier, Peacock & Jones.*

Solicitor for the respondent: *A. A. McGrory.*