DOBIECO LIMITED ..... APPELLANT;

AND

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

1965

*Nov. 15, 16
Dec. 14

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Taxation—Income tax—Deductions—Underwriting and trading firm—Loss on sale of interest in oil syndicate—Inventory asset—Fair market value—Year in which loss sustained—Income Tax Act, R.S.C. 1952, c. 148, ss. 12(1)(a), 14(2), 27(1)(e).

The appellant company had obtained an interest in an oil syndicate, and the total of its contributions to the syndicate amounted to some $80,000. The syndicate agreement was an oral one. The syndicate's drilling was unsuccessful and its funds were exhausted in 1956. In March 1957, the appellant refused to contribute further funds to the syndicate, and although the other members of the syndicate could have terminated the appellant's interest therein, they continued to treat him as a member indebted to the syndicate. In 1958, the appellant sold its interest in the syndicate to another syndicate member for $1. The appellant treated the $80,000 as a loss suffered in 1957, and by virtue of s. 27(1)(e) of the *Income Tax Act*, carried it back and deducted it from its 1956 income. The Minister disallowed the deduction on the ground that the loss was not sustained in the 1957 taxation year. The Exchequer Court held that the loss was not deductible until 1958. The appellant company appealed to this Court, where another question (regarding inventory valuation) was raised but later abandoned.

Held: The appeal should be allowed.

The appellant company was entitled to the deduction claimed. The realized trading loss occurred in June 1958 when the appellant sold its interest in the syndicate. However, it was admitted that this interest was an inventory asset and that, in computing its income for the taxation year ended March 31, 1957, the appellant was entitled to value the interest at its cost or its fair market value whichever was lower. The evidence established, on a balance of probabilities, that on March 31, 1957, the fair market value of the appellant's interest in the syndicate did not exceed $1.

Revenu—Impôt sur le revenu—Déductions—Négociant en valeurs mobilières—Perte sur vente d'une part dans un syndicat—Biens décrits dans un inventaire—Juste valeur marchande—Année dans laquelle la perte est survenue—Loi de l'Impôt sur le revenu, S.R.C. 1952, c. 148, arts. 12(1)(a), 14(2), 27(1)(e).

La compagnie appelante avait obtenu une part dans un syndicat constitué en vue de l'exploitation pour la découverte du pétrole, et le montant total de ses contributions se chiffrait à quelque $80,000. Le contrat entre les associés était un contrat verbal. Le forage fait par le syndicat n'a pas eu de succès et en 1956 les fonds du syndicat étaient épuisés. En

*PRESENT: Cartwright, Fauteux, Martland, Judson and Ritchie JJ.

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mars 1957, la compagnie appelante refusa de contribuer d'autres fonds au syndicat, et quoique les autres membres auraient pu mettre fin au contrat avec l'appelante, ils ont continué de la traiter comme un membre endetté envers le syndicat. En 1958, l'appelante a vendu sa part dans le syndicat à un autre membre du syndicat pour la somme de $1. L'appelante a considéré le $80,000 comme étant une perte survenue en 1957, et se basant sur l'art. 27(1)(*e*) de la *Loi de l'Impôt sur le revenu,* l'a rapportée et déduite de son impôt pour l'année 1956. Le Ministre a refusé la déduction pour le motif que la perte n'était pas survenue durant l'année de taxation 1957. La Cour de l'Échiquier a jugé que la perte n'était pas déductible avant 1958. La compagnie en appela devant cette Cour. Une autre question (concernant l'évaluation de l'inventaire) a été soulevée devant cette Cour mais a été subséquemment abandonnée.

Arrêt: L'appel doit être maintenu.

La compagnie appellante avait droit à la déduction réclamée. La perte commerciale est survenue en juin 1958 lorsquel l'appelante a vendu sa part dans le syndicat. Cependant, il est admis que cette part était un bien décrit dans un inventaire et que, en calculant son impôt pour l'année de taxation finissant le 31 mars 1957, l'appelante avait droit d'évaluer la part au prix coûtant ou à sa juste valeur marchande selon le moindre des deux. La prépondérance de la preuve était à l'effet que le 31 mars 1957, la juste valeur marchande de la part de l'appelante dans le syndicat n'excédait pas la somem de $1.

APPEL d'un jugement du Juge Cattanach de la Cour de l'Échiquier du Canada[1], confirmant la cotisation du Ministre. Appel maintenu.

APPEAL from a judgment of Cattanach J. of the Exchequer Court of Canada[1], affirming the Minister's assessment. Appeal allowed.

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

G. W. Ainslie and M. A. Mogan, for the respondent.

The judgment of the Court was delivered by

CARTWRIGHT J.:—This is an appeal from a judgment[1] of Cattanach J. dismissing an appeal from the appellant's assessment for its taxation year ending March 31, 1956.

While additional matters were dealt with in the Court below the appeal to this Court raised only the two following questions:

(i) Whether the learned trial judge erred in finding that the appellant was not entitled in valuing its 1956 closing inventory of securities

[1] [1963] Ex. C.R. 348, [1963] C.T.C. 143, 63 D.T.C. 1063.

to make a deduction for known costs of sale of items included therein at market value, viz. $21,105.56 for brokerage payable on sale, and $1,648.23 for security transfer tax payable on sale, and

(ii) Whether the learned trial judge erred in finding that the appellant was not entitled to write down from $80,568.38 to $1.00 its inventory asset consisting of its interest in a syndicate, referred to as "the Jerd Syndicate", in the course of valuing its closing inventory on March 31, 1957 and in holding that the loss of $80,567.38, which was admittedly sustained by the appellant in respect of this syndicate, should be treated as having been sustained in a later year.

After some argument had been addressed to us on the first of these points it was abandoned by counsel for the appellant because it appeared that, even if the argument in respect of it were successful, the amount of the deduction claimed would be offset by an error in calculation in respect of other items in the closing inventory. I mention this in order to make it clear that this question having been withdrawn from our consideration we express no opinion upon it.

Turning to the second question, it is common ground that the appellant's interest in the Jerd Syndicate was an inventory asset, that in computing income for the taxation year ending March 31, 1957, the appellant was entitled to value it at its cost or its fair market value whichever was lower, that the cost of the asset to the appellant was $80,568.38 and that in its balance sheet for the year ending March 31, 1957, the appellant did in fact value it at $1.

The question becomes one of fact, whether the evidence established, on a balance of probabilities, that on March 31, 1957, the fair market value of the asset did not exceed $1.

The appellant was incorporated on December 23, 1954. Prior to this date a partnership known as Draper Dobie and Company carried on business in two branches, an underwriting and trading branch and a commission branch. On its incorporation the appellant took over the underwriting and trading business formerly carried on by the partnership. Among the assets acquired from the partnership was the interest in the Jerd Syndicate. In March 1955, the partnership had contributed $50,000 to the Syndicate. The appellant made further contributions bringing the total investment up to $80,568.34. The dates of these further contributions are not fixed with precision but it is clear that the latest of them was prior to March 31, 1957.

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The partners in Draper Dobie and Company included Mr. H. W. Knight and Mr. Geo. W. Gooderman who are now President and Vice President of the appellant.

Before the appellant was incorporated, Mr. Robert Bryce, a mining engineer and promoter and manager of mining and oil exploration and development companies was interested in an area in Alberta adjacent to the British Columbia border which he hoped would prove to be oil producing. He first obtained a reservation which he later converted into lease holdings. It was a condition of the leases so obtained that Mr. Bryce should expend $200,000 in exploration. The area consisted of 40,000 acres in all, but a 25 per cent interest in it had been acquired by another party. The expenditure of $200,000 by Mr. Bryce would entitle him to a 75 per cent interest so that he would own the leasehold in 30,000 acres while the other party owned 10,000 acres. The area of 40,000 acres was unsurveyed. The 10,000 acres owned by the other party consisted of a corner of each section, the balance being owned by Mr. Bryce. Because of the fact that the area was unsurveyed it followed that the limits of the respective holdings of Mr. Bryce and the other party could not be clearly defined.

In order to raise the amount of $200,000 which was to be expended as a condition of the lease, Mr. Bryce formed a syndicate. Mr. H. W. Knight, Mr. Knight's father and Mr. Gooderman personally participated in this syndicate. The amount of $200,000 was raised through the syndicate so formed and was expended in the drilling of an oil well on the property. The amount of $200,000 was exhausted in drilling without oil being discovered and a company was formed under the name of Jerd Petroleum Company, Limited which then became the owner of the leasehold interest in the 30,000 acres. The members of the syndicate became shareholders in Jerd Petroleum Company, Limited in proportion of their participation in the syndicate and the syndicate was dissolved.

In order to finance further drilling, Mr. Bryce, who has been the prime mover throughout, formed a second syndicate. This second syndicate is the Jerd Syndicate with which we are concerned. Draper Dobie and Company was a member of this syndicate and as indicated above made an

expenditure of $50,000 as its proportionate share. It was this interest which was acquired by the appellant from the partnership.

The members of the Jerd Syndicate were Mr. Bryce, 10 per cent, Mr. Wayne, 10 per cent, Amerex Oil, 20 per cent, Decalta Oil, 30 per cent and the appellant, 30 per cent. There were subsequent changes in proportion and membership which are not material but the interest of the appellant remained a constant 30 per cent. Jerd Petroleum Company, Limited, owned a half interest in this venture and contributed half of the funds expended and the Jerd Syndicate owned the remaining half interest and was obligated to contribute one half of the funds to be raised. Jerd Petroleum Company, Limited was not a member of the Jerd Syndicate.

The Syndicate agreement was not reduced to writing. The custom in the trade was to conduct such arrangements orally and if necessity should arise to commit the arrangement to writing at a later time. It was understood, however, that each member of this syndicate was required to put up an amount of money in proportion to his membership interest each time an assessment was called and if the member did not meet the assessment then that member's interest was lost and the remaining members were to be offered the opportunity to take up the interest of the member in default.

The purpose of the appellant in entering into the Jerd Syndicate was two-fold, first, if oil were discovered the appellant would participate in the benefits thereof and second, if success attended the venture, there was a tacit understanding, though an unwritten one, that the appellant would be given the first refusal to underwrite the shares in any company which might be formed to acquire and operate the oil or gas field.

Jerd Syndicate, in conjunction with Jerd Petroleum Company, Limited, sank the well to a depth of 4,779 feet. At that depth harder rock was encountered than had been anticipated. A heavier drill would be required to penetrate deeper, but because of the cost involved, drilling was stopped on March 9, 1956, and has not since been resumed.

At the time drilling ceased the syndicate's funds on hand were exhausted, but the obligation to pay the annual lease rental of $30,000, being $1. an acre, continued, a payment in

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that amount falling due on July 4th of each year. Jerd Petroleum Company, Limited was responsible for $15,000 of the annual rental and the Jerd Syndicate was responsible for an equal amount. The appellant's proportionate share of this liability was $4,500 for July 4, 1957. The appellant did not pay this amount into the syndicate.

Mr. Bryce, in his capacity as head of the Jerd Syndicate, called on Mr. Knight in March 1957, for the purpose of obtaining the appellant's payment of $4,500. Mr. Knight as president of the appellant, informed Mr. Bryce that the appellant did not intend to contribute this or any further sum. The appellant's interest in the Jerd Syndicate was not terminated upon this default as it might have been under the terms of the syndicate agreement and the appellant continued to be looked upon as a member of the syndicate by the other members. The syndicate treated the appellant as a member which was indebted to the syndicate in the amount of $4,500. A further payment of rent was falling due on July 4, 1958. In March 1958, Mr. Bryce again approached Mr. Knight for the appellant's contribution. Mr. Knight reiterated the appellant's previous decision to participate no further in the Syndicate and offered to sell the appellant's interest therein to Mr. Bryce for $1. and the assumption of the appellant's outstanding obligation to the Syndicate of $4,500 and of the further obligation of $4,500 becoming due on July 4, 1958. Mr. Bryce consulted the other members of the Jerd Syndicate who agreed to Mr. Bryce purchasing the appellant's interest.

On June 5, 1958, the appellant executed an agreement for sale of its interest in the Jerd Syndicate for the consideration of $1. in cash and the assumption of the appellant's outstanding obligation of $4,500 and a future obligation of $4,500 due on July 4, 1958.

The consideration so paid was $4,501 but, as is pointed out by the learned trial judge, this has no bearing on the amount of the appellant's alleged loss of $80,567.38 because if the obligation of $4,500 had been paid by the appellant then the loss of $80,567.38 claimed would have been increased by an amount of $4,500 and when the monetary consideration received was deducted from that greater figure, the amount of the loss would remain constant at $80,567.38.

The learned trial judge after setting out the facts recited above went on to hold that the appellant had suffered a loss of $80,567.38 which was properly deductible for income tax purposes and that it remained to decide when the loss occurred. The reasons of the learned trial judge continued as follows:

> While it was possible that the appellant's interest in the syndicate might have been forfeited in March, 1957 by reason of the appellant's failure to pay its assessment of $4,500 in accordance with the verbal syndicate agreement, nevertheless, the appellant's participation was not ended at that time. The syndicate did not act upon the default, but continued to treat the appellant as a member indebted to the syndicate in the amount of the default. The appellant, on its part, also considered itself a member otherwise it would not have been able to sell its interest to Mr. Bryce as it did on June 5, 1958, some fourteen months later. In my opinion the loss was not in the fiscal year ending March 31, 1957, but in the 1958 (sic) taxation year.

With the greatest respect to the learned trial judge I find myself in agreement with the submission of counsel for the appellant that this reasoning leads to the conclusion that as a matter of accounting the realized trading loss occurred in June of 1958 but leaves unanswered the question whether the fair market value of the asset, admittedly then still owned by the appellant, did not exceed $1. on March 31, 1957.

The evidence relevant to this question consists of the inferences to be drawn from the recital of the facts set out above and from the testimony at the trial of Mr. H. W. Knight, Mr. Greenwood, who is the auditor of the appellant, and Mr. Bryce.

I have considered with care all the evidence of these witnesses bearing on this point and have reached the conclusion that it should be found as a fact that by March 31, 1957, the fair market value of the appellant's interest in the Jerd Syndicate did not exceed $1.

In coming to this decision I am influenced particularly by the following matters.

(*a*) Prior to March 31, 1957, Mr. Knight had clearly formed the opinion that the asset had ceased to be of any value and was willing that the appellant should forfeit it rather than make any further contribution and he had so advised Mr. Bryce.

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(*b*) The auditor of the company after going into the matter with Mr. Knight shared his opinion and certified the appellant's balance sheet accordingly.

(*c*) Drilling on the Syndicate property had ceased on March 9, 1956, and no further drilling had been done up to March 31, 1957, or indeed up to the date of the trial, in June 1962.

(*d*) No favourable results had been obtained from the drilling that was done.

(*e*) The funds of the Syndicate were exhausted but the liability to pay rentals continued.

(*f*) The appellant in fact sold its interest for $1. in June 1958, and nothing had occurred between March 31, 1957, and June 1958, to alter the market value of the interest.

As against all this there was the opinion of Mr. Bryce that the property was still worth holding, but this opinion has not been vindicated by subsequent events and does not appear to have been shared by the other members of the Syndicate, none of whom were willing to take over their proportionate share of the interest which the appellant relinquished.

Considering the whole of the evidence it appears to me to be shewn that on the balance of probabilities the correct finding is that on March 31, 1957, the fair market value of the appellant's interest in the Syndicate was not more than $1.

For these reasons I would allow the appeal, set aside the judgment of the Exchequer Court and direct that the assessment be referred back to the respondent to be amended in accordance with these reasons. While the appellant raised other points in the Court below and one other point in this Court on which it did not succeed it has succeeded on a substantial issue and is entitled to its costs in this Court and in the Exchequer Court.

Appeal allowed with costs.

Solicitors for the appellant: Stikeman and Elliott, Montreal.

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