STERLING ROYALTIES LIMITED.....APPELLANT;

AND

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

1946

*Oct. 29
*Dec. 20

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Income tax—Revenue—Costs of drilling oil well—Income on production—Assessment—Deductions for development cost and depletion—Method of ascertaining allowances—Discretion of the Minister of National Revenue—Income War Tax Act, R.S.C. 1927, c. 97, s. 5 (a).

The appellant company, in the course of its business, drilled and operated an oil well in Alberta, which proved productive. In its income tax return for 1934, a loss was shown of $17.25 in the operations for that year. However, an assessment was made on a taxable income of $8,584.25, which assessment was affirmed by the Minister of National Revenue. The appellant company contended that no proper or sufficient amount was allowed for depreciation in respect of costs of development, that is, the drilling of the well. The amount allowed in the assessment by the taxing authorities was a proportionate amount fixed with reference to the value of production in the taxation year. The decision of the Minister was affirmed by the Exchequer Court of Canada. On appeal to this Court,

Held that the discretion of the Minister of National Revenue was not exercised in a manner contrary to the provisions of the *Income War Tax Act* (s. 5 (a)) nor can the method of ascertaining the allowances, used in this case, be termed unjust and unfair. The appeal must be dismissed.

*PRESENT:—Kerwin, Hudson, Taschereau, Rand and Estey JJ.

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STERLING ROYALTIES LIMITED v. THE MINISTER OF NATIONAL REVENUE

APPEAL from the judgment of the Exchequer Court of Canada, Maclean J., dismissing the appeal of the appellant company to that Court from the affirmation by the respondent of the assessment under the *Income War Tax Act* on an income tax return for the fiscal year 1934.

H. S. Patterson K.C. for the appellant.

H. W. Riley and *A. A. McGrory* for the respondent.

The judgment of Kerwin, Hudson and Taschereau JJ. was delivered by

HUDSON J.:—This is an appeal from a judgment of the late President Maclean of the Exchequer Court of Canada dismissing an appeal to that court from the respondent's affirmation of an assessment under the *Income War Tax Act*.

The appellant in the course of its business drilled an oil well which proved productive. In their income tax return for 1934 a loss was shown of $17.25 in the operations for that year. However, an assessment was made on a taxable income of $8,584.25 and on appeal this was confirmed by the Minister.

The appellant gave notice of dissatisfaction on a number of grounds but these have been reduced to a claim that no proper or sufficient amount was allowed for depreciation in respect of costs of development, that is, the drilling of the well.

The amount allowed in the assessment was a proportionate amount fixed with reference to the value of production in the taxation year in question, whereas the company claimed that the amount allowed should have been governed by the cost of development.

This and incidental questions were fully discussed in the court below and I am in entire agreement with the views expressed in the judgment of the learned trial judge in the case of *National Petroleum Corporation* v. *The Minister of National Revenue* (1) adopted by him in the present case. I will quote the final paragraph of that judgment:

> But I do not think it can be said, in all the circumstances of the case, that the discretion of the Minister was exercised arbitrarily or haphazardly, or contrary to the provisions of the act, or contrary to well established

(1) [1942] Ex. C.R. 102.

practice, or upon what can be said to be obviously unsound principles, or that the allowances made can fairly be termed unreasonable, unjust or unfair. The points in issue seem to have been the subject of careful consideration by the taxing authorities, in respect of matters about which there may well be a variety of opinions. The fact that in the assessment of the appellant for 1939, and since upon actual costs, over a period of years, and not upon gross income or net income, does not impugn the validity of the discretion exercised by the Minister in 1938 and earlier years, and I do not think such an argument is a tenable one. The Minister having exercised his discretion in the manner I have already described, and having allowed deductions for depreciation and development, and also for depletion or exhaustion, that I think is the end of the matter, and I do not think I can usefully add anything further. I have not been satisfied that the assessment in question should be disturbed. My conclusion therefore is that the appeal must be dismissed and with costs.

For this reason I think the appeal should be dismissed with costs.

The judgment of Rand and Estey JJ. was delivered by

RAND J.:—The question raised in this appeal is whether the Minister of National Revenue has validly exercised a discretion in his award to the appellant of what are called development and depletion allowances in respect of the sinking and operation of an oil well in the Turner Valley field of Alberta. The section of the *Income War Tax Act*, R.S.C. 1927, chapter 97 by which provision is made for such allowances is as follows:

5. "Income" as hereinbefore defined shall for the purposes of this act be subject to the following exemptions and deductions:—

(*a*) Such reasonable amount as the Minister, in his discretion, may allow for depreciation, and the Minister in determining the income derived from mining and from oil and gas wells and timber limits shall make such an allowance for the exhaustion of the mines, wells and timber limits as he may deem just and fair; and in the case of leases of mines, oil and gas wells and timber limits, the lessor and the lessee shall be entitled to deduct a part of the allowance for exhaustion as they agree and in case the lessor and the lessee do not agree, the Minister shall have full power to apportion the deduction between them and his determination shall be conclusive.

It is objected that the mode of ascertaining the allowance is so unrelated to any accounting basis appropriate to these two items that it is fundamentally wrong and outside the scope of discretion with which the section invests the Minister.

The method used was embodied in an empirical formula. The base figure was the gross income less the amount of royalties payable to superior lessors of the land. The

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Rand J.

combined allowance was then fixed at 25% of the sum so ascertained. That in turn was distributed between the two items in the following manner: the amount for depletion was fixed at 25% of the net income less the allowance for development, but since the net income, at that stage, consisted of the taxable income plus the combined allowance, the amount for depletion was one-third of the taxable income. Now as the taxable income had already been ascertained, the allowance for depletion could at once be calculated, and a deduction of this sum from the total allowance gave that for development and completed the distribution. It will be seen that the relation between the two items will vary as the taxable income, itself dependent on operating expenses, fluctuates; if, for instance, there were no such expenses, the taxable income would be the net income less the allowance, but since the latter is one-quarter of the gross income, the taxable income would be three-quarters of the gross, one-third of which would exhaust the allowance, and thereby attribute the whole of it to depletion. Conversely, if the expenses of operation eliminated the taxable income by reducing the net to the amount of the allowance, depletion would disappear and the total attributed to the development costs.

It is conceded that in certain situations a depletion allowance could be related to net income, but it is said that the conditions of the particular resource here are such as to exclude that as a proper basis of calculation; and it is contended that in the circumstances both of these items, in order to have any accounting foundation, must be directly related, as to development, to the actual outlay, and as to depletion, to some estimate of total resource value.

But treating the distribution within the fixed combined allowance to be material, the method adopted has not been shown to be without foundation in accounting principle. From what appears, it is quite impossible to say that over a wide field of this kind of production the allowance will not in the end work out fairly and justly. Certainly no attempt was made to establish that it will not do that. One basis may, in a mathematical aspect, appear to be more scientific, more exact, than another: but it was not said and cannot be said categorically that the use of this practical formula will not fairly serve the

purpose to be aimed at in administering this feature of the tax act: dealing justly with and promoting enterprise in the development of this kind of natural resource. Assuming then that the exercise of discretion is open to examination on the ground taken, I am unable to say that the Minister's action here was not within the compass of the section, and the appeal should be dismissed with costs.

Appeal dismissed with costs.

Solicitors for the appellant: *Patterson, Hobbs & Patterson.*

Solicitor for the respondent: *C. Fraser Elliott.*