1941
Sept. 12 & 13.
1942
May 30.

BETWEEN:

NATIONAL PETROLEUM CORPORATION LIMITED..... APPELLANT;

AND

MINISTER OF NATIONAL REVENUE ..... RESPONDENT.

*Revenue—Income War Tax Act, R.S.C., 1927, c. 97, secs. 5 (a), 6 (a) & 6 (b)—Capital expenses—Discretion of the Minister—"Disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income"—Income—Costs of drilling oil wells—Deductions for depreciation, development costs and depletion—Appeal from decision of the Minister of National Revenue dismissed.*

Appellant obtained commercial production of oil from two wells which it drilled in Alberta. Appellant was assessed for income tax for the taxation year 1938, which assessment was affirmed by the Minister of National Revenue. An appeal from that decision was taken to this Court.

Appellant contends that certain allowances for depreciation and depletion were made in an arbitrary manner without regard to any principle under the circumstances and were inadequate.

Appellant contends that development costs and all capital costs should be amortized before any income tax is imposed.

*Held:* That the discretion of the Minister of National Revenue was not exercised in an arbitrary manner or contrary to the provisions of the Income War Tax Act, nor can the allowances made be termed unreasonable, unjust or unfair.

2. That the Minister having exercised his discretion and having allowed deductions for depreciation, development and depletion the appeal must be dismissed.

APPEAL under the provisions of the Income War Tax Act from the decision of the Minister of National Revenue.

The appeal was heard before the Honourable Mr. Justice Maclean, President of the Court, at Calgary.

*H. S. Patterson, K.C.* and *A. W. Hobbs* for appellant.

*C. J. Ford, K.C.* and *A. A. McGrory* for respondent.

The facts and questions of law raised are stated in the reasons for judgment.

THE PRESIDENT, now (May 30, 1942) delivered the following judgment:

1942

NATIONAL PETROLEUM CORPN. LTD. v. MINISTER OF NATIONAL REVENUE.

Maclean J.

This is an appeal from a decision of the Minister of National Revenue (hereafter called "the Minister") affirming an assessment for the income tax made by the Commissioner of Income Tax (hereafter called "the Comsioner") against the National Petroleum Corporation, Limited, for the year 1938, in the sum of $13,513.45. The appellant is a company incorporated under the Dominion Companies Act and is engaged in the development and operation of oil bearing lands in the Turner Valley, in the Province of Alberta. Prior to or early within the taxation period in question the appellant had drilled to completion two oil wells, on lands leased and controlled by it, and both wells are still producing oil in commercial quantities.

For the purpose of clarity it may be desirable at the outset to define the meaning attributed to certain terms used throughout this proceeding by the parties thereto. The term "depreciation" apparently is here used in its commercial sense to apply only to wasting fixed assets, such as plant, machinery and equipment, which inevitably diminish in value while applied to the purpose of seeking profits, or advantage otherwise than by purchase and sale. In measuring annual depreciation in such cases the nearest approach to accuracy will ordinarily be obtained by estimating the whole-life period, in years, of each class of industrial plant, with due regard to all known facts, as well as to future probabilities, and distributing the cost, less the estimated remainder or scrap value, to future revenue accounts, in equal instalments over each year of the estimated whole-life period. An illustration of this is the fact that the appellant owned certain plant and equipment, a rotary rig, a truck, an automobile, and certain office equipment, and in 1938 it wrote off certain sums on account of "depreciation" of this plant and equipment, at different percentages, as will later appear, and this deduction was allowed by the Commissioner. Then the term "depletion" is frequently used, and that here has the same meaning as "exhaustion", as used in sec. 5 (*a*) of the Income War Tax Act, and it has reference to an allowance for the "depletion" of the oil reserves recoverable from the appellant's oil leases; it is a measure of the annual exhaustion of the mass or source of oil intended for sale, and ordinarily there the chief

1942

NATIONAL PETROLEUM CORPN. LTD. v. MINISTER OF NATIONAL REVENUE.

Maclean J.

factor to be taken into consideration is the proportion which the volume of oil exhausted or won in any year, and which becomes stock in hand, bears to the estimated whole volume of oil likely to be recovered in the life time of the oil bearing leases. In other words, in the case of an oil producing property, a deduction for "depletion" is an allowance for another division of wasting capital assets before estimating net annual revenue. Another term here employed is "development" or "development costs" and it signifies here only the cost of drilling the two oil wells of the appellant, and apparently does not include the cost of plant and equipment used in drilling the wells, or the casings; and this cost amounted to $219,216.23. The cost of the well casings, that is the steel core which lines the wells, or the holes in the ground, is treated apparently in the same way as plant and equipment, but it is not definitely classified as such, there being apparently some doubt as to whether it should be classified as part of the development cost, or as plant and equipment, but while it is apparently treated as something apart from both yet in practice "depreciation" was allowed here just as if the casings were part of the plant and equipment. However, nothing turns upon this as there is no dispute as to what was allowed as a deduction in connection with the casings.

The appellant filed an income tax return for the year 1938 showing no taxable income. Accompanying the return was the appellant's Balance Sheet, Production Account, Profit and Loss Account, and the Profit and Loss Appropriation Account, for the year in question. The Profit and Loss Account showed a net profit of $166,975.31 for 1938, but against this, in the Profit and Loss Appropriation Account, were written off the following amounts:—

| | | | |
|---|---|---|---|
| Depletion | | | $ 54,608 45 |
| Depreciation:— | | | |
| Plant and Equipment | 15% | $11,689 45 | |
| Rotary Rig | 15% | 12,048 90 | |
| Truck and Auto | 20% | 340 80 | |
| Office Equipment | 10% | 40 59 | 24,119 74 |
| Balance—Written off against Development Expense | | | 88,247 12 |
| | | | $166,975 31 |

These book appropriations against net profits left the appellant without any taxable income for the year 1938, and its tax return for that year was made accordingly.

The Commissioner in making the assessment in question charged back the sum of $54,608.45 written off for depletion, and the sum of $88,247.12 written off for development expenses, but the amount written off for depreciation of plant and equipment, $24,119.74, was not charged back and was therefore allowed. The sum of $5,708.19 was allowed for depreciation of the casings for the two wells, based upon their respective costs, and an adjustment was made in connection with the Workmen's Compensation Board assessments or charges, and in the result there was found a taxable income of $88,025.95 earned by the appellant for the year 1938. The adjustment of the appellant's income tax return as found by the Commissioner appears in the notice of assessment in substantially the following form:—

| | | | |
|---|---|---|---|
| Net profit as per Profit & Loss Account..... | | | Nil |
| Added: Amount written off against Development Expense ..... | | $ | 88,247 12 |
| " Amount written off for Depletion.. | | | 54,608 45 |
| " Adjusted amount of Workmen's Compensation Board charges ..... | | | 487 02 |
| | | | $143,342 59 |
| Less: Depreciation for casing: | | | |
| No. 1 Well, $15,241.46, 15%.... | $2,286 22 | | |
| No. 2 Well, 22,813.17, 15%.... | 3,421 97 | | 5,708 19 |
| Total Income ..... | | | $137,634 40 |

The assessment in question, as adjusted by the Commissioner, thus showed a net profit of $137,634.40 before any allowance for development and depletion.

I may next explain how the Commissioner dealt with the matter of allowances for development and depletion. First, I should state that the appellant's Production Account for 1938 showed a gross income from sales of production in the sum of $218,433.79 before deducting any

1942

NATIONAL PETROLEUM CORPN. LTD. v. MINISTER OF NATIONAL REVENUE.

Maclean J.

operating expenses or anything on account of development costs, but after deducting certain gross royalties paid or payable in that year, and amounting to $65,195.88. I was told by counsel that it had been the rule or practice of the Department of National Revenue for several years prior to and including the year 1938 to make one allowance for both depletion and development in the case of the Alberta oil producing properties, reached by taking 25 per cent of the gross revenue of such oil properties, after allowing for over-riding royalties, and this allowance was to be the maximum amount to be allowed for both development and depletion. In the case of the appellant, for the year 1938, this allowance would be 25 per cent of the sum of $218,433.75, or $54,608.45, and this amount would be apportioned between development and depletion. I would infer that before the adoption of this rule allowances were made for development and depletion on another basis, but that was not, I think, explained to me. Now the $54,608.45 thus allowed for both development and depletion was apportioned in such a way that 25 per cent of the net profit, after the allowance made for development, was allowed for depletion, and the balance of the $54,608.45 would be the allowance for development. In order therefore to ascertain the precise amount to be allowed for development the amount to be allowed for depletion had first to be determined. The formula by which this was worked out was, I think, rather clearly put by Mr. Ford in his written argument, and he expressed that in the following way:—

*1938 Assessment*

| | |
|---|---|
| "Net Income before Development and Depletion Allowances ..... | $137,634 40 |
| Less Development and Depletion Allowances of 25% of gross proceeds from production, less over-riding royalties..... | 54,608 45 |
| Taxable Income ..... | $ 83,025 95 |

*Apportionment of Development and Depletion Allowance:*

| | |
|---|---|
| Depletion is 25% of the net income after all other allowances have been made. Taxable income is, therefore, 75% or 3/4ths of net income. | |
| 3/4ths of net income=taxable income or.. | 83,025 95 |
| 1/4th of net income=depletion or..... | 27,675 32 |
| Total Allowance ..... | 54,608 45 |
| Less Depletion Allowance..... | 27,675 32 |
| Development Allowance ..... | $ 26,933 13" |

By this method of apportionment the allowance for development depends upon the flow or yield of the oil wells, the larger the flow or yield of the wells the larger the allowance for development, and the sooner the development costs would be amortized, while the allowance apportioned for depletion is based on net profits. By this method of computing the allowance for both development and depletion, and by this method of apportionment, the Commissioner determined the net taxable income of the appellant, and this is expressed in the Commissioner's notice of assessment in the following manner:—

| | |
|---|---|
| Net profit before allowance for depletion and development ..... | $137,634 40 |
| Allowance for development costs..... | 26,701 13 |
| Net profit after allowance for development.. | $110,701 27 |
| Allowance for depletion 25% of above net profit ..... | 27,675 32 |
| Taxable income ..... | $ 83,025 95 |

It was upon the net taxable income of $83,025.95 so found that the appellant was assessed for the year 1938 in the sum of $13,513.45, and, as I have already stated, this method of ascertaining the allowance for both development and depletion, and apportioning the same between development and depletion, had been followed for some years.

1942

NATIONAL PETROLEUM CORPN. LTD. v. MINISTER OF NATIONAL REVENUE.

Maclean J.

The total deduction allowed the appellant for depreciation of plant and equipment, for depreciation of the well casings, for depletion, and for development costs, for the taxation period of 1938, may therefore be stated as follows:

| | | |
|---|---|---|
| For depreciation on plant and equipment... | $ | 24,119 74 |
| " " on casings ..... | | 5,708 19 |
| " depletion ..... | | 27,675 32 |
| " development ..... | | 26,933 13 |
| A total of ..... | $ | 84,436 38 |

Before proceeding further I should perhaps explain that the method of computing the deductions for development and depletion in the taxation period in question was varied for the year 1939, and following years. I was informed that, at a conference between the taxing authorities and representatives of oil producing companies in Alberta, the latter urged a definite annual allowance for development, on the basis of the cost of the same, and not on the basis of gross or net income, and that, as a result of this conference, a deduction of 30 per cent, on account of actual development costs, was thereafter allowed by the taxing authorities for the first year, and a diminishing percentage for the next succeeding five or six years, until such costs were fully amortized, and that allowances for depletion were thereafter made on the basis of 25 per cent of net income from production, after allowing for the deduction for development and all other charges. This revised method was seized upon by Mr. Patterson as evidence in support of his contention that the assessment for 1938 had been arbitrarily made, and not upon any sound principle, and while conceding that the revised method of dealing with deductions for development afforded some relief to operators of oil producing properties, yet, it did not go far enough in that amortization of development costs extended over too long a period of years, and that the allowance for depletion was not yet fixed upon any sound principle.

The matters in issue here, and the position taken by the taxpayer and the revenue authorities respectively, are fairly well revealed in certain documents found in the Official File, here in evidence, and to those documents I may now refer. The appellant in its notice of appeal, *inter alia*, states:—

It has been the practice of the Department to treat oil companies in somewhat the same manner as mining companies, but we would respectfully point out to you that oil and mining are two very different things.

Mining Companies before they spend any considerable sum on development, have been able to assure themselves that gold or other ores are available in quantities sufficient to warrant development. On the other hand, oil companies drill wells in likely places picked out by geologists, but there is absolutely no assurance whatsoever that any oil will be found.

It is contended that the drilling of the two oil wells referred to by this Company should be regarded in the light of a single transaction and that part of the expense of producing the oil is the drilling of the wells, and that no profit can be earned from the wells until the total costs have been recovered.

If for any reason the well has to be abandoned, the development costs are a dead loss, as there is no recovery value. In other words, the development costs are an expenditure for which the owner gets no tangible asset. The only return it is possible for the owner to get is oil, and as before stated, part of the cost of obtaining that oil is the drilling cost.

We feel that the fairest way would be for accounts to be taken covering the whole operation when the well finally has ceased to produce and that the whole of the development costs should be written off at that time However we realize that this is not feasible and suggest that the only other fair way is to allow the whole of the development cost as a charge against production until such time as the development costs have been recovered.

It is apparent that the Income Tax Department has endeavoured to meet this situation by new regulations applicable to 1939 income but we contend that even these regulations are only a palliative and do not effect a cure.

We are therefore of the opinion that the Company had no income in the year 1938, and that the assessment is wrongfully issued.

Then followed the decision of the Minister and in one paragraph he states:—

The Honourable the Minister of National Revenue having duly considered the assessment and the objections thereto raised by the appellant, and having reconsidered all the facts connected with the assessment, hereby affirms the same on the ground that the appellant's claim to recover out of production its full capital expenditures in bringing the wells into production cannot be conceded, they being capital expenses the deduction of which is prohibited by paragraph (*b*) of section 6 subsection 1 of the said Act, and that, on the other hand, the allowances made to the appellant in the assessment herein appealed against on account of depreciation or amortization of the said pre-production capital expenditures, on account of depreciation of capital equipment used in the wells, and on account of depletion or exhaustion of the oil wells are reasonable and fair and have been duly determined by the Minister under and in accordance with the provisions of paragraph (*a*) of section 5 of the said Act.

Following the Minister's decision the appellant, by its solicitor, Mr. Patterson, filed with the Commissioner a

1942

NATIONAL PETROLEUM CORPN. LTD. v. MINISTER OF NATIONAL REVENUE.

Maclean J.

Notice of Dissatisfaction as authorized by s. 60 of the Act, which signifies the dissatisfaction of the appellant with the decision of the Minister. I may recite this notice in almost its entirety as it would appear to reflect substantially the grounds advanced by Mr. Patterson on the hearing of this appeal. The notice states:

> National Petroleum Corporation Limited is a Company which has drilled two oil wells in Turner Valley. The Minister of National Revenue has assessed this Company on a basis applicable to ordinary mining Companies. It is submitted that in view of the short life of wells in Turner Valley investment in such wells should not be treated as a capital investment. The Minister has treated development costs in whole or in part as a capital investment when the nature of the undertaking is in reality not a capital investment. The proper assessment should have allowed deduction for expenses in connection with drilling and other development costs.
>
> The Minister, taking the position that the operations of the Company above referred to constitute an investment in capital, has not allowed depreciation to an amount appropriate in the circumstances having regard to the period of the life of wells in Turner Valley and the nature of development of oil wells in said area.
>
> The Minister did not make a proper allowance in the said assessment for depletion in respect of properties developed by the appellant.
>
> The allowance for depreciation of casing in the said well was not sufficient in the circumstances.

The concluding step in this phase of the case was the Reply of the Minister to the appellant's Notice of Dissatisfaction, the important portions of which are:

> 1. That the costs of drilling the oil well and the necessary buildings, roads, etc., were expenses incurred in the creation of capital assets or expenses of putting the taxpayer in a position to earn income and not expenses wholly, exclusively and necessarily incurred in the earning of income within the meaning of section 6 (*a*) of the said Act.
>
> 2. That the said expenses were outlays or payments on account of capital within the meaning of section 6 (*b*) of the said Act.
>
> 3. That the facts and circumstances in regard to the taxpayer's affairs have been considered and the discretionary power referred to in section 5 (*a*) of the said Act (so far as discretionary power in such circumstances has been provided for by the Statute) has been exercised with respect to depreciation of capital assets and depletion of oil wells, and the allowance made is deemed a just and reasonable exercise of the statutory discretion.

I perhaps should add that in his written argument Mr. Patterson made the following submissions in support of the appeal: (1) The Minister has a duty to fix a reasonable allowance in respect to depreciation, (2) the Minister "shall make an allowance" for the exhaustion (or depletion) of the wells, (3) there is nothing to show that the Minister has made any allowance in respect of either

depreciation or depletion, (4) if any allowances have been made they are purely arbitrary and based on no principle having regard to the circumstances of the case, and (5) the actual allowances made are inadequate in the circumstances. These several submissions were in turn amplified but into that I do not propose to enter.

One has only to consult some of the many text books wherein authors of experience discuss the matter of allowances for depreciation of wasting capital assets, and allowances for depletion of mining and gas or oil properties and their cost of development, to learn how difficult is the problem, the variety of views prevailing in respect of the same, and the difficulty of formulating any rule of broad application whereby these matters can be determined with entire satisfaction to all concerned, particularly when the controversy lies between the taxpayer and the taxing authorities and where the net income of the taxpayer has to be determined. The Income War Tax Act provides no rules, in the case of mining and gas or oil producing properties, for ascertaining allowances for depreciation, depletion, or development, and no doubt it was because of a realization of the inevitable difficulties surrounding such matters that this duty was left to the discretion of the Minister. There is no mention of "development costs" in the Act and I assume that in theory and in the strict and proper sense a coal mine shaft, or the shaft of a metalliferous mine, or the hole in the ground through which oil is recovered, is plant and equipment; but it has been found by experience that such development costs had to be treated as a branch or division of the matter of depreciation of plant and equipment, because the problem there cannot be disposed of on the same basis, or with the same approximation to accuracy, as in the case of fixed assets, such as buildings, machinery or equipment, because their life and the life of the industry in which such assets are employed may be measured with some certainty. It was stated that in the case of coal mines allowances for depletion are computed at so much per ton of coal raised, and in other types of mining operations on the basis of a certain percentage of net profits. In computing allowances for depreciation, development and depletion in respect of oil producing properties in the United States, certain rules appear to have been

1942

NATIONAL PETROLEUM CORPN. LTD. v. MINISTER OF NATIONAL REVENUE.

Maclean J.

established, and certain options seem to be made open to the taxpayer in respect of such matters. However, these rules are so complicated that I cannot safely venture upon any explanation of them.

I come now directly to the question here to be decided, and it will be well first to refer to s. 5 (*a*) of the Income War Tax Act, the provision of the statute relevant to the issue here, and as in force at the material time. That section reads:—

> "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. . . . .

I am asked to say that here the Minister exercised his discretion, if at all, arbitrarily, and on no principle having regard to the circumstances of the case; that development costs, and in fact I think it was said all capital costs, should first be amortized before any income tax was imposed, notwithstanding that the Act requires a tax upon net income to be imposed annually, which contention, if sound, would appear to virtually nullify the whole Act, in respect of cases of this kind; and that the actual allowances made were inadequate in the circumstances. It is not, I think, necessary for me to say that the several contentions of the appellant are without merit in the practical sense, or that the allowances made for development and depletion by the taxing authorities were reached by a method which was beyond all controversy. But I do not think that 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 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, I believe, the allowance for development was based 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.

*Judgment accordingly.*